

REGULATORY POLICY INSTITUTE

Assessing the economic significance of the professional legal services sector in the European Union

Professor George Yarrow and Dr Christopher Decker*

August 2012

*Views expressed in this and other Regulatory Policy Institute reviews and reports are those of the authors, and they should not be attributed to any organisation(s) with which those authors are associated. The Institute is a charitable organisation dedicated to the promotion of the study of regulation for the public benefit, and does not itself take positions on the relevant policy issues.

The Institute welcomes general and specific support grants for its various activities. In this case funding for the study was provided by The Council of Bars and Law Societies of Europe (CCBE), and we would like to express our thanks to that body and its members for providing this opportunity to contribute to thinking in an important area of public policy.

SUMMARY

- i. This report assesses the economic significance of the professional legal services sector in the European Union.¹ Its purpose is to contribute to current understanding of the linkages between the sector and economic performance, and to help inform the assessment of policy proposals relating to the future regulation of legal services. An important part of this assessment is an examination of the high-level relationships between the provision of legal services and some of the fundamental institutions of market economies, which are, in economic terms, provided as ‘public’ or ‘collective’ goods.
- ii. The principal conclusion is that economic analysis and evidence suggests that legal services can have wide ranging economic significance through their very close connection with the general institutional architecture of society (sometimes encompassed by a term such as the ‘rule of law’). Moreover, this analysis and evidence suggests that it is not by chance that good economic performance tends to be closely associated with the stable and well-functioning legal systems. Rather the institutions (including laws and norms) of a legal system condition and determine economic performance. Institutions that are stable and credible facilitate economic development and lead to higher levels of economic activity. In addition, although political institutions determine important aspects of the structure of a legal system, and whilst the judiciary determines how given laws are implemented, lawyers actively contribute, through their everyday actions and conduct, to both the shape of a legal system and how effectively it operates and functions.
- iii. Two aspects of the conduct of a legal profession, in particular, appear to be closely associated with the performance of a legal system. First, for a legal system to be effective it is necessary for lawyers to be adequately trained and resourced to perform the tasks required of them. Secondly, given the nature of work that lawyers undertake, the integrity of the profession is significant; there is considerable value in maintaining a culture of professionalism and independence from external influences, including State influence. The implications of these points are two-fold. First, assessment of the legal profession should take account of the wider relationships between a legal system and economic performance. Secondly, although there are some similarities, there are also differences between lawyers and other

¹ In this report we define professional legal services as those services provided by qualified and registered lawyers who are members of a relevant bar association or law society. The definition is intended to capture the activities of solicitors, barristers, attorneys and advocates across EU member states.

professionals; and policies that may in part be based on empirical comparisons of the legal service sector with other professional activities need to be developed around an understanding of the sources of these differences.

- iv. A particularly important relationship between legal services and economic performance stems from the roles that legal services play in facilitating and sustaining markets. The core activity of the professional legal services sector tends to expand market activity throughout the economy, and it is therefore closely linked to economic performance and growth; a feature that distinguishes legal services from a number of other professional service activities with which they are often compared in economic and policy assessments. Immediate implications of this point are that, given the role legal services play in facilitating and sustaining markets:
 - a. It is important that professional legal services markets themselves function effectively, and
 - b. Potential reforms that could affect the quality or quantity of legal services provided require careful assessment in conceptual/analytical frameworks that are broad enough to encompass the wider economic effects.
- v. Having established the wider significance of legal services for markets and market activity, we next identify and describe a number of key attributes of legal services as an area of *transactional* activity.² Existing regulation of legal professionals is part of the institutional structure of these legal services markets, and effective regulation should be based on a close understanding of the nature of the relevant services and transactions that take place. The main conclusion from this examination is an old one: context matters, and good regulation reflects the relevant context. More generally, an important feature of adaptive, well functioning market economies is that the particular ‘rule-books’ that govern economic behaviour, whether formal or informal or some mixture of the two, develop to reflect the challenges of the relevant context to which they apply. Changes to the ‘rule-books’ (i.e. institutions) need, therefore, to be evaluated on their merits, in their specific contexts.
- vi. Our general view of attempts to quantify the economic impacts of the legal services sector on economic performance is that, although they can provide one or two high-level insights and can be helpful in developing new statistics, there are significant limitations to this type of work, and the results of these quantification exercises should be approached with considerable caution.

² The term ‘transactional’ here is used in an economic sense, and refers to the provision of services by a professional lawyer in return for a fee or some other form of remuneration. It therefore encompasses all areas of professional legal services activity, including civil and criminal law.

Having given this general health warning, we tentatively present some statistics and quantitative estimates of the size and ‘value added’ contribution of the European legal services sector. These statistics suggest that:

- There has been sustained growth at the global level in the legal services market over the past decade as a result of economic growth, an increase in international trade and greater economic links between countries.
- At the EU level, and in most Member States, there has been a significant increase in the number of legal services practitioners since 2006 and the number of professionals was estimated at around 1 million in 2010 (by way of comparison, there were an estimated 1.2 million lawyers in the United States in 2010). The growth in the number of legal professionals is expected to increase steadily over the period to 2015.
- There was an average of 1.80 lawyers per 1000 head of population in 2008 in Europe (again by way of comparison in 2008, in the United States, there was an estimated 3.82 lawyers per 1000 head of population). However, the proportion of lawyers per capita in the EU varies significantly from state to state.
- Only limited data are available on the number of legal enterprises operating in Europe, but these suggest that in 2009 there were in excess of 492,000 legal enterprises in the 27 EU member states.
- The estimated value of the legal services market in Europe, as measured by the total revenues received by law firms, was €113.6 billion in 2010.³ Total revenues increased by an estimated 10% (or €10.4 billion) over the five-year period 2005-2010. By 2015, it has been estimated the size of the European market will reach €148.2 billion, representing growth of over 25% on the 2010 estimates.
- Based on 2010 estimates, the UK had the largest share of the European legal services market followed closely by Germany. In total the UK and German legal services markets accounted for just under 50% of the total estimated revenues of the legal services sector in Europe.
- The average revenue per lawyer at the EU level was estimated at €110,270 in 2010 (which is generally the same as the 2005 estimate). However, the average revenue per lawyer varies across different EU member states: for example, the UK and France estimates are considerably above the average,

³ This data is based on material which also includes non-EU Member States such as Norway, Switzerland, Turkey and Russia and the Ukraine.

while the estimates for Italy and Spain are below the average reflecting, in part, the relatively higher number of lawyers per capita in the latter countries.

- It is estimated that legal services revenues amounted to about 1.1% of GDP in 2010 in the five largest European markets. Although, as noted, we are of the view that extreme care should be taken in relying on these estimates, we note that this contribution to GDP is broadly consistent with those presented in previous studies of the EU legal services sector, and with estimates of the contribution of the legal services sector to the US economy (which was estimated at approximately 1.8% in 2007).

vii. In the light of these data and their limitations, we go on to consider some of the econometric studies that have been undertaken on the legal services sector. Our general assessment is that while these types of studies can provide a potentially useful compendium of the different rules/restrictions in the legal profession across the EU member states, there are strong reasons to avoid placing great reliance on this work in policy making. This is because the econometric approach – which depends for its validity on the existence of standardized, consistent and reasonably comprehensive datasets – may not be suited to the issues which arise in legal services, where there is likely to be a need for a detailed and forensic assessment of different professional rule-books in terms of their purposes, their proportionality in relation to these purposes, and their possible effects on economic outcomes. Our own view is that a much more productive approach to understanding regulatory issues in the EU legal services sector lies in detailed, comparative, case-study work, which is capable of approaching issues with a much wider field of vision, and which is much less prone to the neglect/omission of relevant evidence (than are econometric approaches when faced with a situation in which suitable statistical series are not available).

viii. The final section of the report provides some brief comments on emerging trends and regulatory issues in the legal services sector. We note that a number of commentators suggest that the legal services sector may face a considerable period of turbulence in the coming years, particularly as a result of changes in information and communications technologies and the associated emergence of new working practices. This is likely to offer both opportunities and challenges for the profession, and the ability of the sector to adapt to these changes will be critical to its economic performance in the future. There are also a number of possible regulatory developments that could have both direct and indirect effects on the profession, and we briefly discuss some of the economic considerations associated with changes to organisational/ownership rules (such as the introduction of alternative business structures) and possible changes to reserved activities and qualification requirements. Our general

view is that in assessing proposed major changes to policy such as these, the only way in which the economic issues can safely be approached is via case-study assessment of the trade-offs associated with the regulations, based on an examination of likely effects on competition and of wider impacts in terms of quality and consumer confidence. The balancing of these considerations is necessarily a complex exercise, requiring detailed contextual study.

- ix. Consistent with this last point, we do not seek to reach arrive at general conclusions about the emerging issues that we have identified, but simply emphasise one major source of the risks that may lie ahead. It is the fragility and unreliability of policy analysis that relies upon an ‘institutionless economics’, and which, in particular, is prone to mis-categorise restrictions of human conduct (such as might be embodied in ethical systems, codes of conduct, social norms, etc.) as *necessarily* being restrictions of markets or of market activity. Whilst some constraints on conduct do have the effect of restricting the level of economic activity, very many do not. Indeed good institutional arrangements (another name for certain types of restrictions on conduct) are, on the basis of what we know from the historical record, vital for the economic success of nations.

TABLE OF CONTENTS

1. Introduction.....	1
2. The wider significance of legal services to economic welfare	4
2.1 High-level linkages between a legal system and economic institutions	5
2.2 The relationship between lawyers, institutions and economic performance ..	12
2.3 Implications for policy and regulation.....	21
3. Legal services and markets.....	23
3.1 Lawyers and markets	24
3.2 Illustrations from recent economic history	28
4: Legal Services as a Transactional Activity	31
4.1 Heterogeneity in legal services transactions.....	31
4.2 General characteristics of demand for legal services	33
4.3 General characteristics of the supply of legal services.....	38
5: Assessing the contribution of the legal services Sector to the EU economy	49
5.1 Statistical estimates.....	51
5.2 Econometric approaches	59
5.3 Summary.....	72
6: Emerging Trends and Regulatory Issues	74
6.1 Some emerging trends	74
6.2 Competition issues.....	76
6.3 Regulation of ownership and business structure	79
6.4 Reserved activities and qualifications requirements.....	82
6.5 Summary.....	83

1. INTRODUCTION

1. This report assesses the economic significance of the professional legal services sector in the European Union. Its purpose is to contribute to current understanding of the linkages between the sector and economic performance, and to help inform the assessment of policy proposals relating to the future regulation of legal services. The approach adopted is wider in its scope than those to be found in a number of other reports that have sought to assess the economic significance of the legal services sector. In particular, in addition to estimating the direct quantitative significance of the sector in terms of contributions to economic aggregates such as GDP and employment, we focus on the broader significance of legal services for economic performance by way of their contributions to the effective functioning of the basic institutions of market economies.
2. As discussed more fully in the sections that follow, the wider role of the legal services sector in the effective functioning of market economies is sometimes overlooked in policy discussions relating to the sector. This can result in quantitative estimates that grossly understate the contribution of the sector to economic performance. Consider, for example, the impact on EU economic activity of a substantial fall in the quality of legal services. The effect on economic performance in such a situation could be expected to be substantially greater than any numerical estimate likely to be inferred from a narrow, ‘accounting’ measure such as a consequential fall in legal service revenues. One reason for this is that the revenue numbers tend to be based on *marginal* (as opposed to average), *private* (as opposed to wider, social) valuations of services provided.
3. Although we present evidence on what might be called the ‘direct’ contribution of legal services to the EU economy in section 5, we note at the outset that the inferences that can be drawn from quantification exercises of this sort are necessarily limited. In particular, there are difficulties associated with interpreting the estimates in the absence of a fully specified analytical framework: a high or low number can easily be interpreted in different ways, and it is not entirely clear what the estimates mean in the absence of some pre-specified or *a priori* propositions about what we should expect to see. In this respect, we note that a number of quantitative studies of the legal services professions have focused on benchmarking various sectoral economic indicators against similar indicators for other professional activities (such as comparing employment numbers for lawyers and architects). In the absence of a fully-specified analytical framework, which can account for relevant sources of differences among the professions, such exercises amount to a very crude

form of economic analysis, and they are in our view are only of limited usefulness. In technical economic terms, the studies tend to be subject to ‘specification errors’ in the formulation of the equations to be fitted to the data: in judicial terms, they tend not to take into account relevant evidence (i.e. evidence that is relevant to explaining variations in economic indicators across professions).

4. Thus, although we recognise the existence of at least some value in quantitative indicators of economic significance, we believe that it is critical for the interpretation of such evidence that it be firmly located in a wider economic context, and in a wider assessment framework that is capable of encompassing a fuller range of underlying issues and trade-offs. These more fundamental issues and trade-offs are central to our discussion, in the later part of the study, of some of the emerging trends and current regulatory issues in the legal sector.
5. Having made these preliminary observations on our approach to the study, the remaining sections of the report are structured as follows:
 - Section 2 identifies a number of the high-level connections between the provision of legal services and the fundamental institutions of market economies. The discussion highlights some of the general ways in which legal services can have wide ranging significance for the economic performance of a country, and how lawyers contribute to the relevant processes.
 - Section 3 focuses on the relationships between legal services and those particular social institutions that we call markets. A primary focus of this discussion is the role that legal services play in facilitating and sustaining markets of all types.
 - Section 4 shifts the focus of analysis from the significance of the collective ‘consumption’ of legal services, to the examination of legal services provided on a ‘private’ basis to clients/consumers in one or more relevant markets. Specifically, in this section we identify and describe some of the characteristics of legal services as *transactional* activities (i.e. provision of service by a lawyer to a client, for a fee or other form of remuneration).
 - In section 5, we present and discuss some of the statistical and quantitative estimates of the direct, value-added contribution of the legal services sector to the European economy.

- Finally, in section 6, we examine some emerging trends and regulatory issues, in the legal services sector and briefly comment on them in light of the themes developed in the earlier sections of this report.

2. THE WIDER SIGNIFICANCE OF LEGAL SERVICES TO ECONOMIC WELFARE

6. This section examines the high-level relationship between the provision of legal services and some of the fundamental institutions of market economies, which are, in economic terms, provided as ‘public’ or ‘collective’ goods. To many commentators, particularly those from outside the economics profession, the linkages between legal services and wider economic welfare appear to be obvious. However, some recent economic assessments of legal services have tended to focus on the contribution of legal services in a narrow, transactional sense – such as their contribution to the GDP numbers of the EU economy, or to measures of levels of competitiveness in specific activities. The wider perspective on the contribution of the legal services sector to a market economy is often either ignored or discounted in economic assessments of the profession, and legal services are therefore generally bundled together with other types of professional services. This ‘narrow’ approach to issues reflects a widespread tendency within economics toward over-abstraction, and toward methodologies that focus on the analysis of only a small number of ‘variables’.
7. For the reasons outlined in this section, we consider this to be an unduly limited way of framing the assessment of legal services, which risks ignoring information and evidence that is highly relevant to assessing the overall contribution of legal services to market economies. Put slightly differently, we consider that (i) the wider contribution of legal services to the effective functioning of the institutions of market economies cannot sensibly be ignored in policy assessments, (ii) that these contributions are important for economic performance, and (iii) the contributions are affected by public policies. In addition, we suspect that a failure to recognise, or to incorporate into the analysis, the wider contribution of legal services accounts for some of the reasons why lawyers and economists sometimes talk across each other on questions relating to the legal profession.
8. In previous work, we have referred to legal services as potentially having a special complexion as compared with other professional services, for the reason that the services comprise part of the broader social-political-moral landscape that comprises a society’s legal system, or “The Law”. In that work we noted that, whilst recognition of this point did not have any immediate and direct implications as to the appropriate form of regulatory oversight of such services, or even whether such oversight is warranted, recognition of the point does nevertheless serve to indicate that a narrow economic assessment could

fail to take account of relevant evidence concerning social, political, cultural and symbolic aspects of the practice of law.

9. In the discussion that follows we build on this last point and adopt a broad perspective on the contribution of legal services to economic welfare. Specifically, we focus on the following issues:
 - The ‘high-level’ connections between factors such as the stability and credibility of legal regimes and the effectiveness of other economic institutions (particularly markets and contractual activity more generally).
 - The independence of the legal profession, and how this can affect the provision of legal services and economic activity.
 - The links (which can be inferred from global and historical comparisons) between the level of development of legal systems and the level of economic activity.
 - The relationships between legal systems, the stability of property rights, and incentives for investment.
 - The relationships between legal services provision and ‘the rule of law’ which appear most clearly to distinguish these services from those provided by other professionals.

2.1 High-level linkages between a legal system and economic institutions

10. At the most general level, the linkage between legal institutions and economic activity can be expressed in terms of certainty/stability and adaptability. A well-functioning legal regime is one that is stable and provides certainty to market participants at reasonable cost, allowing them to transact in confidence, while being sufficiently adaptable to new and evolving circumstances, and to the new opportunities for social and economic transactions that such evolution frequently brings.
11. While easily stated, getting the required balance between stability and adaptability is not a straightforward task; laws can be stable but too rigid, leading to reduced experimentation and innovations, or alternatively, laws can be too flexible and change too frequently, resulting in market participants restricting their behaviour for fear of a future (adverse) change in the law.

Historical evidence

12. The close connection between the law and economics can be seen in historical works that have examined the development of trade, and the relevant rules for governing that trade, from ancient Greece to the *lex mercatoria* in medieval Europe, to more recent debates about how intellectual property laws affect innovation and economic progress.⁴ Economic history also reveals that the way in which laws are implemented/applied can impact on the output of an economy (what is produced and how much is produced) and the distribution of income associated with that output (distributive justice). In sum, economic history suggests that a legal system can have substantial, real economic effects, which affect the relative positions of different individuals and entities within a society, as well as the overall economic performance of a society.

13. Economic scholars in the institutional economics tradition have examined the high-level connections between legal regimes, economic institutions and economic performance in detail. The work of Nobel laureate Douglass North, in particular, has focused on how institutions – defined to include both formal laws and more informal behavioural norms – relate to economic change and performance.⁵ He concludes that:
 - Institutions establish the incentive structures of society, and the political and economic institutions are, in consequence, the underlying determinants of economic performance.
 - Economic performance is shaped by, among other things, an admixture of formal rules, informal norms and enforcement characteristics. In particular, an essential part of economic development is the creation, and respect for, property rights.
 - There is nothing automatic about the evolution of the kinds of conditions that will permit low-cost transacting in the impersonal markets that are essential to productive market economies, and which characterize modern European economies. These conditions are structured by institutions; that is, by laws and norms.
 - History suggests that societies and economies that get “stuck” tend to embody belief systems and institutions that fail to confront and solve new

⁴ The high-level linkages between the economy (commerce) and law are also captured in the influential works of many leading scholars. These include the writings of Adam Smith, Frederick Hayek, Max Weber and a number of more recent Nobel laureates in the institutional economics tradition (including Ronald Coase and Oliver Williamson, as well as Douglass North).

⁵ See for example, D North (1981) *Structure and Change in Economic History* (W.W Norton and Company) especially chapter 15.

problems of societal complexity. That is, the institutional structure fails to adapt to emerging changes in the wider socio-economic environment.

14. While these points might seem somewhat removed from discussions of the more tangible contributions of a legal system to economic performance, North's general thesis is a simple and persuasive one: economic performance is not simply the result of production opportunities and consumption choices, but also how the institutional framework of a society (i.e. laws and norms) shapes and constrains the behaviour of economic actors.

15. The enforcement of laws is also, in North's view, of central importance to economic performance. He notes that: '*the inability of societies to develop effective, low-cost enforcement of contracts is the most important source of both historical stagnation and contemporary underdevelopment*'.⁶

Legal development and economic development

16. There is a long list of economic studies that have sought to trace the relationship between a society's legal system and economic development, dating from Max Weber to more recent work by the World Bank and other international organizations on the role that the 'rule of law' can play in facilitating growth in developing economies.

17. The question in economic terms is often motivated by a desire to understand why different countries and regions of the world have displayed different levels of economic growth (the same question that motivated Adam Smith to write *The Wealth of Nations* during European Enlightenment period). One stream of economic analysis has sought to develop and test different models of economic growth, which are based on the assumption that differences in cross-country GDP per capita can be explained by differences in the endowments of the factors of production (physical capital, labour and more recently human capital). While these models have provided insights into the drivers of economic growth in different countries, they have generally failed to account for all of the significant factors that explain differences in observed economic development across countries and regions.

18. Another stream of analysis has sought to dig deeper into the causes of cross-country variations in economic growth. This work, again associated with Douglass North and colleagues, starts from the position that the various factors identified by many growth economists as causing economic growth (innovation, capital accumulation, education etc.) are not actually *causes* of

⁶ D North (1990) *Institutions, Institutional Change and Economic Performance* (Cambridge University Press), page 54.

economic growth, but rather are aspects of economic growth.⁷ It is then argued that the fundamental explanation of economic growth, and differences in growth across countries, lies in the nature and structure of a country's *institutions*.

19. The hypothesis that institutions can explain differences in economic growth has been tested extensively in economic research. An influential study by economists from MIT and Harvard University (Acemoglu, Johnson and Robinson, 2005) found support for this hypothesis both theoretically and empirically, and concluded that institutions are the fundamental cause of differences in economic development.⁸ Similarly, a recent survey of studies on institutions and economic development concluded that legal institutions have a '*first-order*' impact on economic development.⁹
20. Perhaps of most relevance to the current discussion is the related point that institutions are *endogenous* to a society. That is, the institutional framework of a society – its laws and other rules and norms – is determined by the society or some segment of it. In effect, in some way or other, societies or countries collectively *choose* or *evolve* the institutions that apply to them, and these choices can be seen to have real economic consequences.

Legal institutions and market economies

21. More specifically, it has been argued that legal institutions are important for the development of a market economy because of the nature of commercial transactions.¹⁰ In market economies it is often (though far from always) the case that transactions are sequential – meaning that the receipt of products and payment for the product (the 'quid' and the 'quo' in the *quid pro quo* of trade) – occur at different times, and that the seller and the buyer are not familiar with one another (ie; are anonymous) and may even be located in different parts of a country. The separation of the delivery of a product from its payment, coupled with the greater anonymity of transactions, raises the potential for parties to the transaction to behave opportunistically and to renege on any promises that have been made. While these problems could be addressed to some extent through reputational mechanisms (assuming that there are future interactions) or through other more informal mechanisms

⁷ D North and R Thomas (1973) *The Rise of the Western World: A New Economic History* (Cambridge University Press) page 2.

⁸ D Acemoglu, S Johnson and J Robinson (2005) 'Institutions as a Fundamental Cause of Long-Run Growth' in *Handbook of Economic Growth* (Elsevier, North Holland) page 386. See also D Acemoglu and J Robinson (2012) *Why Nations Fail: The Origins of Power, Prosperity and Poverty* (Crown Publishers).

⁹ T Beck (2012) 'Legal Institutions and Economic Development' in *The Oxford Handbook of Capitalism* (Oxford University Press).

¹⁰ *Ibid.*

(such as violence or collective shaming), it is obviously the case that, as markets and trading opportunities develop and grow in size, there is a need for rules and laws to govern the transactions between anonymous or relatively unfamiliar trading parties.

22. These points focus on the relationship between institutions and economic growth in a general way, but it is also useful to consider some of the more specific ways in which particular attributes of a legal system can contribute to economic performance. In his survey of the relationship between legal institutions and economic development, Beck (2010) identifies some of the different channels through which legal institutions assist economic development including:

- In societies where property rights are well defined and protected, people can focus their activities on entrepreneurial activities and innovation rather than focusing time and resources on preventing potential expropriation or predation.
- The certainty that a legal system will protect property rights increases the confidence of investors and encourages investment and growth in an economy (see below for a fuller discussion of this point).
- An effective legal framework, in which people and enterprises have sufficient trust that their rights will be protected, can encourage transactions to occur within the ‘formal’ sector of the economy rather than the ‘informal’ sector. Another way of putting this point is to say that, where the law is assumed to be effective and fair, there is less of a demand for corruption or other informal methods of ensuring contracts are enforced.
- Legal institutions can affect corporate structure and governance arrangements, which in turn can influence firm size. In particular, the legal framework – and most importantly those parts of it relating to contract law – can affect the decisions of a firm as to whether to expand its operations internally, or to out-source its activities. That is, the legal institutions can affect the ‘boundary’ of the firm, and hence the structure of markets (e.g. whether they contain more or fewer competing firms). Where there are strong legal institutions that allow for the enforcement of contracts, it is likely that firms will be more willing to engage in market transactions than they will be in countries where the possibilities for contract enforcement are less developed.

- Finally, the quality of legal institutions have been linked to financial sector development, an area which is critical to economic growth. A related observation is that international capital does not necessarily flow to countries where capital is in short supply, and where the gains are likely to be substantial on that count, but rather often flows to countries where there are lower returns but where there are more effective enforcement institutions that provide greater security in returns.

23. By way of further illustration of this type of economic literature, Cooter identifies some particular types of institutions (ie: laws) in modern economies and briefly shows how they interact with specific economic concepts.¹¹ For example, he notes that contract law and labour laws can create incentives for effort/innovation by workers, and can thereby help to improve labour productivity. Similarly, contract law and corporation law help mitigate the risks associated with the use of one party's assets by other parties. Moreover, and perhaps most obviously, contract laws and other commercial laws affect the transactions costs associated with commercial transactions. Antitrust laws are central to ensuring that competition in the economy is effective, while laws requiring various disclosures and guarantees assist in addressing problems associated with asymmetric information (where one party knows much more about some relevant aspect of a transaction than the other). Finally, environmental and health and safety laws can assist in addressing problems associated with economic 'externalities' (whereby harm or benefit from an economic activity or transaction is caused to third parties who are not directly involved in the activity or the transaction).

Property rights, incentives and credibility

24. A recurring high-level connection between a legal system and economic performance concerns the protection and stability of property rights, and in particular, the incentives that stable and well-defined property rights can create for economic activity. Indeed, it is often argued that the central contribution of a legal system to a market economy is that it defines property rights, protects holders of these property rights and allows for the transfer of property rights. All of these factors are seen to facilitate market-based transactions, and to lead to improvements in economic performance.

25. An important way in which a legal system protects property rights is by restricting the ability of the state and its agencies to expropriate, or confiscate, property that is owned by individuals or corporations without due cause. So

¹¹ R Cooter (1996) 'The Rule of State Law Versus the Rule-of-Law State: Economic Analysis of the Legal Foundations of Development' *John M. Olin Working Papers in Law, Economics, and Institutions* 96/97-

important is this legal protection that in some cases the protection against ‘takings’ or expropriation by the state is secured in the constitution of a country. This is intended to make the commitment of the state not to expropriate property credible, and to therefore increase the confidence of private parties to invest.

26. The potential for future expropriation of property rights by the state has been examined in detail in the context of investment in utilities and other large-scale infrastructure projects. The issue is of particular concern in some developing countries where substantial investments are required in the network industries (gas, electricity, telecommunications and transport infrastructure), but where the legal institutional framework is such that there is often an inadequate protection for investors. A particular concern of investors in such circumstances is that, once they make an investment in infrastructure, the government will seek to lower the prices that can be charged for use of the relevant assets (in order to reap short-term political benefits), and hence that they (investors) will not make a sufficient return on their investment.¹² Among the factors that can lead to this situation are a lack of adequate institutional checks and balances on state actions, including weak avenues for legal redress.
27. Of particular relevance to the current discussion is the effect that the potential for future expropriation of property rights has on the *ex ante* incentives of a firm to invest or expand its activities. Specifically, it is often the case that a firm will recognize the potential for future adjustments to its property rights, and will factor this expectation into its behavior. Put differently, where firms have an expectation that there is a risk that their property rights might be adjusted, or where there is some uncertainty as to the stability of property rights, then it might decide not to invest in that country or to limit their potential exposure (perhaps by demanding a higher level of compensation to account for the future risk of expropriation). This point simply reinforces the statement made earlier that capital investment, including in particular foreign investment, generally does not flow freely to countries where legal institutions are considered to be ineffective and to provide insufficient protection against expropriation.
28. Although the above points have focused on the effects that unstable property rights can have on the incentives of firms to invest, it is also clearly the case that similar effects can be observed in terms of individual and household

¹² Spiller and Tommasi find, for example, that: “*Indeed, sunk assets expropriation has been more prevalent in the developing world than direct utility takeovers or expropriation without compensation*”. P Spiller and M Tommasi (2005) ‘The Institutions of Regulation’ in C. Menard and M. Shirley, Eds. *Handbook of New Institutional Economics* (Springer).

economic activity. For example, if individuals have limited confidence that a contract entitling them to use property in a particular way, or to receive payment for the transfer of property, will be respected and enforceable under the legal system, it would be expected (and rational) for them to limit their exposure to these types of contracts. In short, they might be expected to engage in fewer trading activities with parties with whom they are unfamiliar.

Summary

29. In this section we have briefly examined some of the economic analysis and evidence that links the stability and adaptability of legal system to economic performance. Although this discussion may at first sight appear to be somewhat removed from the issue of the contribution of the legal services sector to the economic welfare of EU member states, there are two points in particular that emerge from the discussion which we think are of critical relevance:

- Firstly, a substantial body of evidence suggests that well-functioning legal systems contribute to, and facilitate, economic development and performance. The analysis and evidence suggests that it is not by chance that good economic performance tends to be closely associated with the stable and well-functioning legal systems, rather the institutions (including laws and norms) of a legal system condition and determine economic performance.
- Secondly, institutions are *endogenous* to a society. That is, the institutional framework of a society – its laws and other rules and norms – is, one way or another, determined by the society or some segment of it. Although the development of institutions tends to be heavily influenced by the *unintended* consequences of human conduct, it is nevertheless within the remit of a society to (collectively) *choose* to seek to influence the structure of its institutions, and these choices can be expected to have real economic consequences. Choices made in relation to the regulation of professional legal services provision are an illustration of the point.

2.2 The relationship between lawyers, institutions and economic performance

30. We have endeavoured to establish the general point that the institutions of a society, including laws and other social norms, are linked to economic performance, and indeed can be a critical and important determinant of such performance. However, this leads on to a further question, which is more

closely related to the issues that are the focus of this paper, and that is: what role do lawyers play in the development of the legal system of a society?

31. Another way of putting the question might be: how are legal systems formed and maintained? At a very general level, there has been (and continues to be) much intellectual debate about how the attributes of a legal system are developed and maintained, ranging from perspectives that laws, and legal systems, do, or should, reflect a superstructure of morality (natural law); to perspectives that a legal system reflects the underlying power structures of a society (Marxist and critical legal scholars); to the view that laws and legal systems are intimately connected with the norms and practices of underlying societies (socio-legal interpretations).
32. Our interest here is, however, more narrowly focused on the role that lawyers play in the formation and maintenance of legal systems in a more practical, day-to-day way. One response to the implied question might be that, apart from judges, lawyers do not play a major role in shaping a legal system, and that it is politicians and judges who determine its shape and form in a particular jurisdiction. However, while it is undoubtedly true that political institutions determine important aspects of the structure of a legal system, and whilst the judiciary determines how given laws are implemented and applied, we consider that it is also the case that, in going about their ordinary or everyday business, lawyers also play a significant role in these matters.
33. In some ways it is obvious that lawyers, through their actions and conduct, contribute both to the shape of a legal system and how it functions. Indeed, the suggestion that lawyers do not contribute to a legal system is akin to suggesting that the general health of individuals of a country is determined only by the specific health policies pursued by a government, and that the conduct of individual doctors does not contribute to the outcome.
34. The link between lawyers and a legal system that contributes to economic performance can perhaps be highlighted with the following simple *Gedankenexperiment*. Suppose that a parliament passes a new law, requiring that certain types of contracts to be signed by at least two parties as witnesses. If lawyers who practice in this area do not follow the new requirement, a large proportion of contracts may be legally invalid. In these circumstances, there may be an increase in contested contractual matters in the courts, increased uncertainty among those who had formed an expectation they were beneficiaries of the proceeds of the contract, and, in the context of such uncertainty, a rise in the general level of transaction costs associated with contract making (e.g. augmented by the prospect of court costs). This crude illustration demonstrates how a collective failure of lawyers (e.g. to effectively follow the requirements of a change in law) can affect the legal system in a

specific area, by increasing the transactions costs associated with particular activity, and can lead to adjustments in behavior that are generally harmful.

35. Put simply, having a well-designed set of rules ‘on the books’, which aims to protect property rights and afford citizens all sorts of rights, will be ineffective if, in practice, those responsible for implementing or working with those rules are either under-resourced, insufficiently skilled or subject to external influence (corruption).

Lawyers and the ‘Rule of Law’

36. In recent times, one way in which economists – including those at international organisations such as the World Bank, UNDP, and USAID – have sought to promote economic development and improve economic performance has been by advocating the adoption of the ‘rule of law’ in developing or transitional countries. A particular focus of these organisations has been on fostering conditions that will allow for the development of particular types of institutional frameworks, on the basis that the relevant frameworks can be expected to facilitate higher levels of economic development and growth.

37. There are obviously various interpretations of what constitutes the ‘rule of law’ and it is a term that is sometimes associated with different ideological positions (which imply that the substance or content of the rule of law should comprise particular values or rights, or require specific actions such as privatizations). For current purposes, we have adopted a more neutral definition, starting from that proposed by Tamanaha (2011) which is that “*the rule of law means that government officials and citizens are bound by and generally abide by the law*”.¹³ This definition recognizes the point that there is a distinction between a general legal framework on the one hand, and the substance of the laws which are enacted under that framework on the other hand. The substantive laws can be unfair or discriminatory – racial segregation laws are the classic example –but might still satisfy the rule of law if the rules are specified *ex ante* and both government officials and citizens abide by them. In this respect, the rule of law requires only that the laws are stable and predictable and they are observed both by citizens and the state.

38. Given what has been said about the significance of the activities of lawyers, however, it is appropriate to augment this ‘bare bones’ definition of the rule of law with reference to the conduct of lawyers in going about their ordinary business, as captured for example in standards of behaviour such as

¹³ B Tamanaha (2011) ‘The Rule of Law and Legal Pluralism in Development’ *Hague Journal on the Rule of Law*, page 2.

‘independence’ and ‘integrity’. Thus, it might be said that the rule of law requires not only that officials and citizens are bound by the law and generally abide with it, but also that the behaviour of those most intimately involved with law in practice is bound by codes and norms of conduct that go beyond the law itself. Indeed, it may have been the relative neglect of the second of these requirements that has limited the practical success of the aforementioned ‘rule of law’ projects (see below), notwithstanding that the proposition that sound legal frameworks serve to facilitate economic growth and development is firmly rooted in academic work on institutions.¹⁴

39. Various commentators have assessed efforts by international bodies, such as the World Bank, to assist in building the ‘rule of law’ in developing or post-conflict societies as disappointing.¹⁵ The difficulties associated with developing and maintaining a culture based on the ‘rule of law’ in these countries provide valuable insights when considering the role that lawyers play in a legal system. One recurring factor that is seen to have contributed to the disappointing progress is the quality, integrity and skill of the relevant, national legal profession. Many assessments of poor performing, or failing, legal systems conclude that, if they are to be effective, efforts to reform these legal systems cannot simply require that a country follow a narrow ‘rule of law’ approach, by mandating that citizens and state officials follow the laws. Rather, to be effective, such reforms require the active involvement of the participants in the legal process. The notion of “*Bottom up*” law coined by Professor Robert Cooter of UC Berkeley requires a community of judges, lawyers and scholars to find social norms, state them authoritatively, and selectively enforce them. The rule of law can’t come from top down planning. It needs the support of intermediate institutions and a community of judges,

¹⁴ Douglass North, for example, has argued that economic growth and the rule of law are intimately connected, noting that “*while economic growth can occur in the short run with autocratic regimes, long-run economic growth entails the development of the rule of law*”. The leading French economist, Jean-Jacques Laffont drew a similar conclusion in his study on regulation and development, noting that: “*Another shortcoming of developing economies is the weakness of the rule of law. Poor enforcement of laws and contracts biases contracting toward self-enforcing contracts or leads to costly renegotiations*” (page 4) DC North (1993) ‘Economic Performance Through Time’ *Nobel Prize Lecture*. JJ Laffont (2005) *Regulation and Development* (Cambridge University Press) page 4. See also D Acemoglu and J Robinson (2012) *Why Nations Fail: The Origins of Power, Prosperity and Poverty* (Crown Publishers), chapter 11.

¹⁵ In a recent World Bank staff paper, for example, it was noted that: “*The numerous rule of law assistance programs in post-conflict or fragile countries have so far resulted in few lasting consequences. Some individual programs have had a modicum of success, when evaluated according to their programmatic strategies or institutional goals, but even then most have not built institutions that might outlast the donor presence. Overall, rule of law reform in the post-conflict context has only minimally impacted on the complex and somewhat intangible social end goals associated with rule of law reform, which can be defined as: (i) a government bound by law (ii) equality before the law (iii) law and order (iv) predictable and efficient rulings, and (v) human rights.*” K Samuels (2006) ‘Rule of Law Reform in Post Conflict Countries’ *World Bank Social Development Working Papers*, No 37, page 15.

lawyers and scholars who can shape law into reality.¹⁶ In the context of efforts to develop the rule of law, Tamanaha (2011) has emphasized the importance of training programmes focused on lawyers as well as the judiciary:

“Take judicial reform – a favorite of law and development projects. Training judges accomplishes little by itself. A sizeable group of trained legal practitioners is needed to handle cases and to help develop legal practices and shared legal knowledge.”¹⁷

40. Two aspects of the conduct of a legal profession appear to be particularly closely associated with the performance of a legal system, both of which are linked to central themes developed in later sections of this paper. The first aspect relates to the skills and abilities of legal professionals; in short, whether lawyers are adequately trained and resourced to perform the tasks required of them. The second aspect relates to the integrity of the profession, and in particular the extent to which the culture is one of professionalism and independence from external influences, including state influence.

The skills and capability of the profession

41. In section 4 of this report we discuss in some detail issues surrounding the quality of legal services, and how concerns about poor quality of provision is an important factor that underpins the economic rationale for some form of regulation of the legal profession (including self-regulation). However, consistent with our focus in this section, we briefly examine the evidence on how the skills of lawyers relate to the development of effective legal systems, such as those based on the notion of the rule of law.
42. Evidence suggests that alongside independence, the quality of lawyers is an important determinant of how a legal system functions. Research examining the development of the rule of law in China in the 1990s, for example, has concluded that, while there had been improvements in the quality and performance of China’s legal profession, significant problems remained at that particular time, which continued to have adverse effects on both commercial activity and the exercise of individual rights. One study noted that:

“[M]any lawyers lack the training and skills to provide the quality legal services sought by businesses engaged in increasingly sophisticated transactions or by defendants seeking to take advantage of China’s revised criminal procedure laws. Despite efforts to raise the standards for becoming a

¹⁶ R Cooter (1996) ‘The Rule of State Law Versus the Rule-of-Law State: Economic Analysis of the Legal Foundations of Development’ *John M. Olin Working Papers in Law, Economics, and Institutions* 96/97-3, page 47.

¹⁷ Tamanaha op cit, page 3.

lawyer, many attorneys have received no formal training and some lack even a college education¹⁸

The independence of the legal profession

43. A second aspect of lawyer's conduct which can affect the performance of a legal system relates to the extent to which lawyers operate professionally and independently. This aspect is closely related to what might be termed the 'culture' or ethical values of the profession. The integrity and independence of the profession are perceived to be important attributes of legal work. Bar associations and representative bodies around the world often refer to 'independence' as being a critical and central attribute of the legal profession, and one that must be preserved and maintained. However, in some economic assessments of the legal profession at least, such references to the desirability of independence and integrity are considered to be irrelevant, or are dismissed out of hand as self-interested pleas of the profession. We note that these (dismissive) assessments themselves tend to take relatively narrow views of the economic issues involved, for example by relying (explicitly or implicitly) on economic models that leave no role for cultural or ethical factors in economic life (i.e. on 'economics without institutions'). In contrast, and consistent with our general approach to the economics, it is in our view necessary to work within a broader economic framework that at least allows for the possible existence of such factors and effects, (i.e. does not exclude them *a priori*) in order to be able to assess the actual significance of the relevant effects.
44. Lawyers are often compared to other professionals (accountants, architects, dentists and doctors), but there are important ways in which the tasks and activities of lawyers are distinguishable from those of other professions, particularly in relation to issues regarding independence. In considering this difference, we note first that there are different aspects to the notion of the independence of lawyers, including: (1) independence from concerns about the wider policy impacts of their advocacy; (2) independence of their advocacy from their own personal views; (3) independence from popular opinion; and (4) independence from the state.
45. It is often argued that the professional task of a lawyer is a partisan one. Lawyers are required, through their work, to advocate the private interests of their clients, rather than necessarily pursue a wider public good. Indeed, a good lawyer is sometimes defined to be one who most effectively advocates the lawful interests of their client, and is not generally affected by considerations of whether this advocacy will result in an outcome that is

¹⁸ R Peerenboom (2002) *China's Long March Toward the Rule of Law* (Cambridge University Press) page 15.

adverse to a wider public policy agenda. For these reasons it is only in rare circumstances that a lawyer can seek to override the private interests of their client in the interests of the public good.

46. There are many cases where lawyers are required to represent a client whose position may be inconsistent with government policy, and/or with the perceived public interest. To take a hypothetical example, imagine a government policy commitment to the development of electricity only by renewable energy sources (specifically wind power), which required new electric power lines to be built. In building these power lines, access to private land may be required and the relevant landowner may instruct a lawyer to challenge this access. The lawyer who successfully advocates the private position of the client in these circumstances may delay or set back the wider policy agenda, an outcome which might be seen to be contrary to the wider public interest.

47. This need for lawyers to represent their client's interests first, and to remain independent of consideration of the broader public policy implications of their actions, is succinctly captured in the following reasoning of the US Supreme Court:

*"... the duty of the lawyer, subject to his role as an 'officer of the court,' is to further the interests of his clients by all lawful means, even when those interests are in conflict with the interests of the United States or of a State. But this representation involves no conflict of interest in the invidious sense. Rather, it casts the lawyer in his honored and traditional role as an authorized but independent agent acting to vindicate the legal rights of a client, whoever it may be."*¹⁹

48. In conducting their activities, lawyers should also act in ways that are independent of their own personal beliefs/values. A lawyer may be required to draft a separation agreement involving a distribution of assets s/he considers objectionable, or be required to represent an unsympathetic client in a custody matter. According to current norms, the lawyer in such matters cannot, through poor advocacy, supplant their client's lawful interests with his/her personally preferred outcome.

49. There may be circumstances where a lawyer has personal difficulties in representing a client – either because of his/her own value system or for other extrinsic reasons – and he/she may in consequence choose not to represent that client. However, this is the generally the exception rather than the norm and,

¹⁹ *In Re Griffiths*, 413 U.S 717 (1973).

in the ordinary course of their work, lawyers advocate their clients' legal positions without regard to any subjective considerations of morality.

50. The third aspect of independence follows directly from the points made above, and relates to the fact that legal reasoning is deliberately and consciously distinct from popular reasoning. Put slightly differently, lawyers are professionally required to respect and adhere to legal processes and procedures, even though the observance of such processes and procedures may, in some circumstances, result in substantive outcomes that may appear unfair or inconsistent with public policy and/or popular opinion. However, the procedural rules, and their observance by lawyers, may be crucial to the integrity of the legal system, especially in so far as it creates increased certainty for economic actors.
51. The final aspect of the independence of the legal profession is independence from the state. Indeed, a characteristic of a significant fraction of professional legal work in modern economies is that it involves directly challenging state power and the decisions of the administrative agencies of the state. This aspect of independence is obviously compromised if lawyers are either intimidated by the State or prone to conflict of interest.
52. The economic implications of norms of professional independence, which are properly regarded as part of the institutional infrastructure that governs economic life, can perhaps best be seen by contemplating the implications of their absence. Consider, for example, evidence of the adverse effects that can occur when lawyers are not sufficiently independent of the state, or are intimidated by the state or other powerful interest groups. In 1950s Latin America, it has been argued that lawyers '*avoided filing politically controversial claims before judges*' and '*were not willing to use legal remedies and the justice system to defend their rights*'²⁰, a situation that is said to have contributed to the emergence of authoritarian political regimes. The resistance of lawyers to authoritarian regimes has been argued to be lowest where lawyers were seen as state officials and the state was the great employer of lawyers (i.e. a market for independent lawyers did not really exist).²¹
53. The problems associated with lawyers being insufficiently independent of the State and of powerful interests groups have continued to be noted in later periods. In relation to 1990s China, for example, it has been argued that:

“Although lawyers are no longer considered “workers of the state” as in the Mao era, the independence and autonomy of the legal profession remains

²⁰ R Pérez-Perdomo (2006) “Rule of Law and Lawyers in Latin America” *The ANNALS of the American Academy of Political and Social Science 2006*, page186.

²¹ Ibid.

limited...The legal profession also suffers from rampant professional responsibility violations. Many lawyers survive and in some cases thrive based on their guanxi (connections) with judges and government officials rather than their legal skills. Given the current environment in which they must operate, including widespread corruption and a poorly trained judiciary, lawyers often feel they have no choice but to rely on guanxi as much as on legal arguments. ...The lack of professionalism of lawyers contributes to difficulties in implementing the law and establishing a law-based order.”²²

54. There are nevertheless some trade-offs to be recognized in relation to some of the aspects of independence listed above. Thus, whilst independence from public policy and from public opinion can often be good things, particularly when what is at stake are the rights of individuals, they are not necessarily positive factors in all circumstances. For example, an overly fastidious attachment to legal procedures and processes over all other considerations can lead to outcomes that, if contrary to settled public opinion and settled public policies, might be seen as unfair, unjust or even irrational in terms of substantive outcomes (i.e. what may be described as ‘substantively rational’ outcomes are displaced by ‘procedurally rational’ outcomes). In such cases, legal formalism can contribute to an erosion of trust and confidence in economic institutions that has obvious, negative implications for economic progress. As with many other economic activities that are generally desirable, it is possible to have ‘too much law’ (and see further the ‘too many lawyers’ debate discussed later in this report).

55. In summary, a number of general points might be drawn from this discussion of the concept of ‘independence’. Among these are:

- That there is a connection between the independence of lawyers, the implementation of law and the development of a rule of law. As the examples show, where lawyers are not sufficiently independent this can affect which legal matters get challenged (i.e.: which rights are enforced) and the manner in which they are challenged.
- Professional independence is not something that can be mandated by fiat, but appears to be closely associated with the prevailing culture of the profession.
- The notion of ‘independence’ is not, as sometimes suggested, a hollow notion in the context of the legal profession. It plays a critical role in the maintenance of the rule of law and, as such, is it is something that will be recognized and taken into account by any economic analysis

²² Peerenboom, op cit. page 15.

that pays attention to institutional factors. As discussed in later chapters, this may have implications for the consideration of any potential changes to the regulation of the legal profession.

- On the other hand, pursuit of the notion of ‘independence’ can be taken too far, particularly when attempting to justify legal formalism that leads to outcomes that are seriously ‘out of step’ with widely shared social views and norms concerning fairness, justice and economic effectiveness.

Lawyers as shapers of the law

56. Lawyers, through their advocacy, can be agents of social and economic change. Famous civil rights cases in the United States and elsewhere attest to this ability. Advocacy which shapes the law, also effects economic and social behavior. For example, the quality of legal advocacy regarding what properly constitutes a tax avoidance scheme under a EU Member State’s laws has significant implications for the behavior of large corporations. Similarly, legal argumentation as to what constitutes an abuse under EU competition law can have an impact, through the behavioural changes of economic actors, on EU competitiveness, innovation and economic performance.

57. For this reason, it is often noted that, in modern economies, an active and well performing legal profession contributes to the process of building up a substantial body of legal knowledge. In Common Law systems, in particular, it is evident that arguments made by lawyers that are accepted by a court become part of a body of legal precedent, influencing or binding later decisions.²³ In this respect, lawyers are argued to be direct *participants* in law making; they can make The Law.

2.3 Implications for policy and regulation

58. What do all of these fairly general observations imply for policy as regards the legal profession, including any regulatory arrangements? Recall that we are interested in this section in exploring the wider contribution of the legal profession to economic welfare, and in this context, the main points which emerge from the above discussion include the following:

²³ J Moliterno (2009) “The Lawyer's Role in a Contemporary Democracy, Promoting Social Change and Political Values, The Lawyer as Catalyst of Social Change” Fordham Law Review vol 77 (4), page 1559.

- (i) A substantial body of analysis and evidence suggests that well-functioning institutions (including laws and regulations) can have direct effects on economic performance. Institutions that are stable and credible facilitate economic development and lead to higher levels of economic activity. In addition, the characteristics of institutions, including legal systems, are endogenous to a society: through their choices and their conduct, members of a society can collectively influence the types of institutions that develop, and such institutional development can have major economic consequences.
- (ii) Although political institutions determine important aspects of the structure of a legal system, and the judiciary determines how given laws are implemented, lawyers also contribute, through their actions and conduct, to both the shape of a legal system and how effectively it operates and functions.
- (iii) Two aspects of the conduct of a legal profession appear to be closely associated with the performance of a legal system. First, for a legal system to be effective it is necessary for lawyers to be adequately trained and resourced to perform the tasks required of them. Secondly, given the nature of the work that lawyers undertake, the integrity of the profession is an important aspect of the institutional structure or framework of the economy. In particular, there is economic value in maintaining a culture of professionalism and independence from external influences, including State influence.

59. The principal implications of these points for the rest of this paper are twofold. First, the institutional effects associated with attributes of the legal services sector, and the impact of these effects on economic performance, cannot legitimately be ignored in economic or regulatory impact assessments relating to the legal profession. Any sound assessment of the legal profession needs to take account of the wider relationship between a legal system and economic performance. Secondly, although there are some similarities, there are also some important differences between lawyers and other professionals, and policies based on a comparison of the legal service sector to other professions should be developed around an understanding of the sources of these differences.

3. LEGAL SERVICES AND MARKETS

60. Having considered some of the ways in which legal services can have wide ranging economic significance through their very close connection with the general institutional architecture of society – encompassed by a term such as the ‘rule of law’ – we now turn to the relationships between legal services and those particular social institutions that we call markets. The significance of these more specific relationships is that markets are more directly and more obviously connected to the economic performance of societies than many other types of social institutions. Two aspects of the relationships will be examined:

- The roles that professional legal services play in facilitating and sustaining markets in general.
- The nature of legal services markets themselves, i.e. the institutional structures that govern the supply of legal services on a transactional basis.²⁴

The first of these aspects is discussed in this section, while the latter is addressed in section 4.

61. The central conclusion of this section is that the core activity of the legal services sector tends to expand markets in goods and services generally²⁵, and is therefore closely linked to economic performance and growth. This is a distinguishing feature of legal services, and one that differentiates them from a number of other areas of professional services activities – such as dentistry or architecture – with which they are sometimes compared in economic and policy assessments.

62. There are important implications of this point for current discussions of reform in professional legal services markets themselves. In particular, given the role that legal services play in facilitating and sustaining economic activity in markets generally, any changes that may potentially impact on the quality or quantity of legal services needs to be carefully assessed within a broad economic framework. Among other things, such an assessment should take account of whether the changes are likely to lead to benefits to consumers as a whole in terms of: building confidence in markets, lowering the transactions costs of market trading, and increasing the overall level of economic activity.

²⁴ See footnote 2.

²⁵ Subject to the qualification, already made, that it is possible for the incremental contribution of legal activity to become negative when such activity is carried out to excess.

The key point in this respect is that any adverse impacts on economic performance associated with ill-considered reforms to legal services are likely to be of a greater magnitude than the adverse effects arising from ill-considered reforms to professions that do not share this market expanding characteristic.

3.1 Lawyers and markets

What is a market?

63. If each of a random sample of recent economic graduates were asked to define a market, it can be expected that a substantial fraction would not be able to provide a coherent and satisfactory answer. The basis for such an expectation is to be found in the facts that:

- markets are social/economic institutions whose function or purpose is to facilitate the exchange of goods and services, which they do by reducing the costs of carrying out such exchanges, (i.e. reducing ‘transaction costs’); and
- the dominant theorising in academic economics rests upon models of exchange/markets that make the assumption that transactions costs are zero.

64. If transactions costs are zero, however, there is no function for markets to perform. They therefore tend to become a ghostly, unexplained presence in the theoretical economic reasoning; a term without substance.

65. It is clear from economic history that markets can take on a variety of institutional structures. In medieval Europe, for example, many fairs and markets were entrepreneurial activities organised by individuals on the basis of a franchise from the sovereign or local political authority. The promoter of the market provided not only the physical facilities for the market, but established basic sets of rules/regulations, provided security for those engaged in economic exchange, and might even administer a court or other form of arrangement for the resolution of disputes.

66. Today, such ‘private’ markets may take very different forms, and the linkages with particular geographic locations, which were a feature of medieval fairs and markets, may be broken – as, for example, in the case of screen-based trading of oil, gas, and electricity via energy exchanges, or when using the Ebay or Amazon trading platforms. Nevertheless, the basic functions are the

same. By facilitating communications between potential buyers and sellers, and by providing services that help reduce trading risks such as theft and fraud, ‘private’ markets are designed to promote economic exchange, motivated by the fact that the profitability of organizing a market tends to increase with the size of the market.

67. Although ‘public’ markets – such as those provided by municipal authorities, and perhaps most commonly encountered in the form of an urban shopping street or centre – are not generally organized ‘for profit’, they too have developed to encourage increased volumes of trade, principally by a variety of measures that can be said to reduce the costs of transacting in the market.

68. As a result of working with theories that abstract from the transaction costs of exchange, there are a number of common misunderstandings that re-appear in the economics research literature on a regular basis. Perhaps the most important – the belief that rules and regulations necessarily operate to restrict transactions/markets – was explained as follows by Nobel laureate Ronald Coase, in the context of highly regulated contemporary commodity and stock exchanges:

“Economists observing the regulations of the exchanges often assume that they represent an attempt to exercise monopoly power and aim to restrain competition. They often ignore, or at any rate, fail to emphasize an alternative explanation: that they exist in order to reduce transactions costs and therefore to increase the volume of trade” [our emphasis].²⁶

69. The point here is not that market rules/regulations are necessarily free of restrictions that limit trade to a greater or lesser degree, but rather that, even when they are extensive, neither are such regulations necessarily restrictive of trade. Faced with the fact of rule books that contain restrictions on human conduct – and all institutions are sets of rules that can be characterised in this way – there can be no immediate inference or presumption that the restrictions serve to restrict the volume of trade (i.e. that they are economically restrictive), even when the relevant rule-books are long in length. Indeed, as a simple matter of empirical observation, freer markets (i.e. markets with lower transactions costs, and therefore fewer obstacles to trade) tend, in practice, to be associated with more rules.²⁷

Some basic economic theory concerning markets

70. The academic neglect of the institutional structures of markets has not precluded the development, in modern economics, of analytical concepts and

²⁶ R. Coase (1988) *The Firm, the Market and the Law* (University of Chicago Press) page 9.

²⁷ D Vogel (1998) *Freer Markets, More Rules* (Cornell University Press).

techniques that assist in understanding some important characteristics of today's markets. Potentially helpful economic concepts and techniques do therefore exist, but they are often to be found in relatively unappreciated specialist areas, such as research on 'platforms' and on 'liquidity' in financial markets.

71. Recent research on 'platforms' in markets, for example, has been developed in response to technological/economic developments such as:

- video games machines, which create a 'platform' of value to both software publishers and end users of that software,
- payment systems such as Mastercard and Visa, which facilitate exchange between card issuers (such as banks) and merchants (who sell to the public), and between card issuers and card holders,
- energy and telecoms networks, which nowadays provide services that sustain wholesale and retail markets for the buying and selling of electricity, gas and various communications services,
- Ebay and Amazon Marketplace, which provide platforms for transactional exchanges across a very wide variety of products.

72. What is not usually recognised is that, in one sense, these developments hark back to earlier histories of privately provided markets. Each platform provider develops a set of rules that, together with other aspects of commercial strategy, seek to encourage increased levels of platform-based transactions, since it is from such transactions that the platform provider derives its income. The developments can be interpreted as leading to an increase in the relative significance of 'private' or 'entrepreneurial' markets in modern economies, and these, along with the analysis of them, appears novel simply because old knowledge (in this case relating to the medieval operation of markets organised 'for profit') had been largely lost.

73. The emphasis on novelty in economic research, which is greatly exacerbated by the incentive structures of the relevant research communities, tends to distract attention from the generality of some of the issues that are being considered, and from the relevance of these recent contributions for areas of regulatory and competition policy that might appear, at first sight, to be remote from video-games, financial networks, energy systems, and on-line trading platforms. *The provision of legal services is a case in point.*

74. It would be inappropriate here to develop the relevant analysis of economic platforms in any great detail, not least because authoritative overviews are

readily available elsewhere²⁸, but a central theme of the research is of major relevance to understanding the economic significance of legal service provision. It can be summarised in the following propositions:

- The benefits that particular economic agents, whether sellers or buyers, derive from participation in a market tend, at least up to a point, to be higher the greater the number of potential counterparties to be found in the market, and the greater the levels of transactional activities of those potential counterparties. Speaking generally, bigger markets tend to offer any potential participant greater opportunities for gains from trade than smaller markets.
- Increased market activity by one participant therefore tends to confer benefits on all other market participants, by increasing the size of the market. The effect goes under a number of different names in economic jargon, depending upon the context in which it occurs – the most common label being ‘network externalities’.
- The number of counterparties and their levels of transactional activity will depend upon what, generically, can be labelled ‘transactions costs’.
- Transactions costs depend upon a whole range of factors, from the costs of ‘money handling’, to issues of confidence and trust, as well as to the matters of interest in this report: the structure of laws and market regulations, and the conduct of lawyers in both the development and enforcement of those laws and regulations, *and in supplying legal services to individual market participants*.
- Specifically, legal services contribute to lower transactions costs via a number of familiar routes: clarifying property rights and facilitating the exchange of property, resolving commercial disputes, assisting in the development of market rules and regulations, improving enforcement of the rules, and so on.
- Effective provision of legal services, by reducing transactions costs and thereby increasing the overall level of market activity, confers economic benefits over and above those connected with the particular services to the particular individuals or companies who purchase them. To the benefit derived from the supply of a legal service to one market participant is to be added the consequent benefits that others derive from the resulting increase in the volume of market transactions. The magnitude of the

²⁸ For example, J Rochet and J Tirole (2003) ‘Platform Competition in Two-Sided Markets’ Journal of the European Economic Association, page 990.

relevant effects will depend upon the particular market context, and, since the institutional structures of markets exhibit great variety, significant variations in the magnitudes are to be expected.

75. As a final observation we note that there is a direct linkage here between relevant parts of technical economic theory and the point sometimes made in less technical economic assessments of the legal services market that there are ‘positive externalities’ associated with legal services transactions.²⁹ Specifically, it is argued that while the quality of a lawyer’s work in a particular matter can confer a direct benefit on those parties associated with a transaction, it can also potentially confer a wider benefit to others who are not parties to the transaction. This argument feeds in to the more general points about the links between good lawyers and advocacy and ‘good’ law discussed in the previous section of the report.

3.2 Illustrations from recent economic history

76. The influence of changes in transactions costs on levels of market activity is readily observable in practice, and, over recent decades, the single most important driving factor in market expansion has probably been the rapid rate of innovation in information and communications technology (ICT). By steadily reducing transactions costs in very direct and obvious ways, ICT developments have, for example, been instrumental in the new markets listed above: video games, card payment systems, telecoms, competitive wholesale and retail electricity and gas markets, and online trading platforms. Over time, these ICT developments are also having, or can soon be expected to have, major effects on more established markets, including parts of the legal services market (see the discussion in section 6 below).

77. The emergence of new forms of markets has tended to draw attention to a number of other, frequently neglected influences on transactions costs and on trading volumes, such as confidence and trust. Illustrations of the economic importance of such ‘indirect’ influences on transactions costs include:

²⁹ It is inappropriate in a report such as this to work through the detail of the theory, but one of the main points can be summarised by noting that the gains from trade from participation in a market by an individual economic agent labelled i might be expressed as $V_i(t_i, N(t_1, \dots, t_i, \dots, t_j, \dots))$, where N is the number of participants in the market, which depends on the full set of transactions costs for all market participants and potential participants, and the lower are these costs, the greater the number of market participants and the higher the value of participation to each (the larger is the market). It can be seen from this formulation that lower transactions costs for, say, economic agent j will confer benefits on economic agent i – lower t_j will increase N , which in turn will increase V_i – and, indeed, on all other market participants. Economic agent j will be willing to pay for legal work that reduces his/her own transactions costs up to an amount equal to the benefits that he/she (agent j) will derive from those lower costs, *but will not be willing to pay for the benefits conferred by lower t_j on others*. This is the source of the positive externality.

- The effort devoted by proprietors of online retail trading platforms such as Amazon and Ebay to develop arrangements which allow for feedback from buyers about the performance of sellers. The resulting, publicly available statistics can be viewed as a contemporary version of buyer-to-buyer recommendations or warnings about products and services, which have played a much longer history in markets where the quality of goods or services supplied is not immediately transparent. Not only does the information guide buyers toward better purchasing decisions, the resulting effects in terms of extra/reduced sales for well/poorly rated suppliers can provide strong incentives for suppliers to develop reputations (see further below).
- Financial guarantees by service providers such as Amazon against non-performance of counterparties to transactions on their platform.

78. By increasing trust in counterparties, or by providing guarantees against performance failure, confidence in the relevant market is increased, and, *ceteris paribus*, the level of market activity will tend to increase.

79. In financial markets, these tendencies are often discussed in terms of the concept of liquidity, and the notions of market activity and transactions costs are reflected in notions such as the ‘depth’ of the market and the ‘spreads’ between traders’ buying and selling prices. In these markets, the effects of a diminution in confidence and trust can eventuate very quickly and dramatically, as when, during the current credit contraction, banks have become nervous of trading with one another in the very short-term markets that are essential for maintaining the liquidity of the banking system as a whole. Liquidity in financial matters can, quite literally, disappear in a matter of days or even hours, which is another way of saying that the market can collapse, with potentially dire consequences if regulatory responses are not sufficiently swift. In effect, the loss of confidence/trust implies a sharp, upward jump in ‘transactions costs’ (the risks of trading increase sharply), which in turn deters transactions (market activity).

80. By virtue of its extreme nature, the current financial crunch has served to expose certain aspects of institutional economics that, whilst having more general relevance, are often not noticed in the other contexts where they also play a major, but not particularly visible role. Since the latter include legal services provision, we will dwell a little longer on the financial services comparison.

81. The causes of the financial crunch have been seen to lie, in part, in a toxic mixture of major political projects (cheap finance to win popularity), and lack

of restraint on the part of bankers and other lenders in the face of financial temptations to lend cheaply to the high risk borrowers favoured by politicians. The lack of restraint amounted to a failure of regulation on at least two major counts:

- There was inadequate self regulation by bankers themselves: unlike lawyers, they were/are not subject to professional ethical codes and associated disciplinary actions capable of exerting a restraining influence in the face of financial temptation.
- Absent self-regulation, the burden placed on public regulation (prudential supervision of banking) became all the greater, and, perhaps unsurprisingly in the light of the common home of public regulators and politicians in the executive branch of government, it proved to be a burden too heavy to bear. In effect, what should have been highly independent banking supervision became, in the name of ‘deregulation’ (and in Europe also in the name of ‘monetary union’) subject to undue political influence.

82. The point to be made here is not that anything resembling a financial crunch can be expected in the event of failures in the supply of legal services; but rather that a very similar economic process is nevertheless at work. Failures in the structure of the legal system, or in the general conduct of lawyers (for example, because of conflicts of interest and associated financial temptations), tend to reduce confidence in markets and make economic exchange riskier/costlier, with potentially negative effects on market activity. Any such deterioration could be expected to occur over much longer periods than in financial markets, but slow decline can be as damaging as short-term collapse, not least because the gradualness of any decline may lead to delay in implementing responsive policies and may be associated with greater difficulties in reversing the trend. For example, there is no ‘remedy’ to a loss of confidence in the ‘rule of law’ that is anywhere close to being as quick and as effective³⁰ as state ownership of banks as a remedy in the face of banking collapse.

83. Having established the wider significance of the ‘output’ of legal services for markets and market activity, we now turn to more specific issues surrounding those outputs and their characteristics when supplied to consumers or customers.

³⁰ Although the implicit assumption of state effectiveness here depends on the creditworthiness of the relevant, sovereign government.

4: LEGAL SERVICES AS A TRANSACTIONAL ACTIVITY

84. The discussions in the previous sections have suggested that lawyers, and the services they supply, support the fundamental institutions of market economies. In this section we turn to the task of identifying, and describing, the salient characteristics of legal services as an area of *transactional* activity (i.e. provision of services by a lawyer to a client, for a fee). Speaking roughly, this marks a transition from considering the collective ‘consumption’ of legal services, often done indirectly and in the absence of specific transactions (e.g. as when society enjoys the benefits of the ‘rule of law’), to examination of legal services provided on a ‘private’ basis to clients/consumers in one or more relevant markets. Existing regulation of legal professionals is part of the institutional structure of these legal services markets, and effective regulation needs to be based on a close understanding of the nature of the relevant services and transactions that take place.
85. The discussion in this section develops the theme, established in the previous sections, that well-performing (or effective) legal services markets provide benefits to consumers as a whole in terms of building confidence in markets, lowering transactions costs and increasing the overall level of economic activity. That is, while legal transactions can confer benefits on the parties directly associated with the transaction, there are also potential externalities associated with such transactions.
86. In what follows we examine some of the characteristics of the effective supply of legal services to consumers who purchase these services. These points are of central importance when considering questions relating to the economic rationale for the regulation of lawyers and legal services provision. Our approach in this section is to first detail some of the general economic characteristics of legal services as a ‘product’. In particular, we focus on some of the characteristics of the demand and supply structures for legal services. This approach is similar to that which has been adopted in previous studies of legal services and the liberal professions undertaken by national competition authorities in various EU member states.

4.1 Heterogeneity in legal services transactions

87. While the discussion is focused on the characteristics of the provision of professional legal services in a general sense, we nevertheless recognise that ‘legal services’ is a broad category that encompasses many different areas of economic activity, and that the structure of supply, and the conditions of

demand, can differ significantly across the different types of legal services provided. For example, the conditions of supply and demand obviously differ as between criminal matters, large corporate/commercial matters, conveyancing etc. An individual or small business may have only very infrequent demand for legal services, while large companies, government and other organizations may be repeat purchasers. Legal services may involve relatively routine matters, or technically complex issues relating to the interpretation of law.

88. Three aspects of the provision of legal services can be seen to be of particular relevance when considering the extent of diversity in the work undertaken by lawyers across Europe. The first aspect relates to the general types of legal activity that lawyers are involved in, for example the extent to which lawyers' work is divided between civil and criminal matters, and between providing different types of advice. On this question, it has not been possible to obtain systematic information across the EU. However, a 2006 study of the legal profession in Denmark suggested that, when measured in terms of turnover, the provision of business advice was by far the greatest area of activity for lawyers in the country, followed by advice relating to property, private advising and civil trials.³¹

89. A second, and related, aspect of diversity in the provision of legal services concerns the consumers of these services. To what extent do lawyers sell their services to business customers, as compared to private individuals or to government/public sector clients? Again, EU wide statistics on this question are not available. The Copenhagen Economics study of Denmark suggests that industry and business services clients generated the most revenue (determined according to turnover for 2004) followed by organisations and private individuals. Public sector clients accounted for only 8% of revenue.³²

90. A third aspect of diversity concerns the relative costs (i.e.: prices charged) associated with different types of legal services transactions. Like other areas of professional services the costs associated with different types of services tends to be greater for less routine, more complex matters, requiring the application of a higher level of skill on the part of the service provider. However, there are factors which potentially distinguish the provision of legal services from other professional services in relation to prices, Specifically:

- First, legal services can involve matters that have high importance for the consumer acquiring the service. At the extreme, they can relate to an individual's fundamental rights, including property rights and

³¹ Copenhagen Economics (2006) "The Legal Profession; Competition and Liberalisation", page 18.

³² Ibid, page 19.

liberty. As discussed in more detail below, this characteristic of legal services, coupled with the non-routine nature of the tasks undertaken, may make demand for certain types of legal services less price elastic (i.e.: less sensitive to price) than for other types of professional services.

- Secondly, in many jurisdictions, a not insignificant proportion of legal services transactions are effectively funded by the state via some form of legal aid assistance. The effects of this on demand for legal services are complex to assess, but the implication of such arrangements is that the state becomes a large customer of legal services, and in some cases determines the price that is paid for particular types of service.

91. It is not our intention to present here a comprehensive assessment of the extent of heterogeneity in the provision of legal services across the EU member states. For current purposes the salient point is simply that whilst, in general terms, all lawyers can be said to provide advice/counsel in relation the law, and whilst all might be subject to broadly similar requirements in terms of standards of conduct and behaviour, there is considerable diversity in the nature of the specialized services that lawyers supply to customers, and also significant diversity among customers themselves.

4.2 General characteristics of demand for legal services

92. Bearing in mind, in light of the above discussion, the limitations of describing legal services transactions in generic terms, it is nevertheless possible to identify some broad general characteristics that affect demand for legal services in many areas and for many clients. Specifically, three general characteristics can be identified as having particular significance for the demand for legal services: the ability of consumers to assess the quality of the product (i.e. the legal service provided); the price of the service; and the ability of consumers to redress problems in the performance of legal services.

The importance of quality and the asymmetric information problem

93. The first general characteristic of legal services considered as economic products, which they share with many other professional services, is that they often combine the supply of specialist knowledge with a specialist skill in the *application* of that knowledge. An important implication of this point is that when some consumers choose between different lawyers in a specific area of law, especially in those areas with which they are irregular or inexperienced buyers, they may not be able easily to assess the *quality* of the different

providers. For this reason legal services are sometimes referred to as being an example of ‘credence good’ in policy discussions and documents.

94. However, since a credence good is defined as one for which the quality of the product cannot readily be determined by the consumer either before or after consumption, not all legal services fall into this category. In particular, frequent/repeat consumers of legal services, or consumers who have regular contact with other repeat purchasers of legal services (such as large businesses or government agencies) will have some capacity to evaluate the product before they purchase.³³ In addition, as the ‘quality’ of legal services can potentially be communicated by various means including word-of-mouth, global directories of lawyers or internet rating sites (such as a ‘rate my lawyer’), even first time consumers can form a view as to the likely quality of the service they will receive.³⁴ In this sense some legal services might be better characterized as a ‘search good’ than a ‘credence good’; that is, information about aspects of what is on offer may not be costlessly available, but the costs of ‘shopping around’ to discover relevant information are not prohibitively high either.³⁵

95. Nevertheless, the general issue these points raise is the potential information difference (or asymmetry) between some consumers of legal services and the suppliers of those services. As we, and others, have previously noted, this is perhaps the most important economic issue which gives rise to a rationale for some form of regulation of lawyers and of the legal profession. While it is not our purpose here to explore the issues surrounding the information asymmetry problem in any detail, we note the following points, which are relevant to the discussion in later sections of this paper.

- Information asymmetry between providers and consumers is not unique to legal services: it occurs in many types of professional services, and in

³³ The provisions of other types of legal services might also be properly characterised as ‘experience goods’. That is, a product or service where the consumer only becomes aware of the quality as it is being consumed (ie: the consumer realises during the drafting of a contract, or during a trial, whether or not they have a good lawyer).

³⁴ There are of course well-recognised limitations to these types of mechanisms. For example, some consumers may simply be unable to assess whether or not the service they received was of a high or low quality (a fact which is complicated in some legal proceedings by the fact that the outcome of a legal matter does not necessarily correlate closely with the quality of the legal service provided). In addition, in some areas, or for some practitioners, there may simply not be enough consumer opinions available to allow others to confidently form an opinion as to quality. Finally, in relation to internet and other collective ratings mechanisms, problems can emerge as to views expressed in such forums which can have a tendency to be a combination of facts, opinions and prejudices. For this reason the opinions expressed in such forums are often correctly viewed with some skepticism.

³⁵ It should be obvious from these remarks that there are no hard and fast distinctions between types of products or services, and that the costs of obtaining information about them, whether on an *ex ante* or an *ex post* basis, can lie along a continuous spectrum of possibilities,

relation to many other services and products.³⁶ As we have noted elsewhere, the important question therefore is not whether or not there is an information asymmetry associated with the provision of some legal services, but rather the extent to which the information asymmetry problem in the context of legal services differs from that of other professional services and of other services/products with characteristics approximating those of a credence good.

- A general proposition typically made is that asymmetry in the quantity and quality of information available to sellers and consumers can result in the ‘over-provision’ of particular services in some circumstances (i.e.: because, for example, consumers are unable to determine whether a service has been provided unnecessarily), or, in other circumstances, in the ‘under-provision’ of services, for example because consumers recognise the risks associated with being unable to distinguish between the quality of different service providers, and avoid these risks through avoidance of the market (i.e. consumers are deterred from obtaining relevant legal services).
- Regulation to address the information asymmetry problem can potentially take a number of forms. One set of policies might be aimed at the provision of greater amounts of information to consumers to enable them to make more considered and informed choices. The downside of such a policy is the potential cost associated with the provision of such information, recognizing that there may be diminishing returns (from a consumer’s point of view) in information provision, particularly in more complex or technical areas of the law. There are, for example, obvious physical limits on the amount of information that individual consumers can feasibly process, and one of the performance characteristics of well functioning markets is that they economise on these information-processing burdens whilst simultaneously ensuring that consumer interests are protected.
- As noted, problems associated with asymmetric information are a feature of many markets, not just legal services, and the most common *market* (as opposed to regulatory) response to the potential problems is through the development of reputations. In economic terms, the reputation for high (or low) quality associated with a particular supplier acts as an important signal to customers and allows them to form expectations regarding the type of service that they will receive. Indeed, it is a common feature of markets that suppliers who have a reputation for high quality are able to charge higher prices and enjoy more demand for their services than

³⁶ Other examples of credence goods that have been suggested include the services provided by: surgeons, optometrists, computer engineers, car mechanics and taxi-drivers.

suppliers who have a reputation for poor or inferior quality services. This can create a strong incentive for firms and individual suppliers both to develop good reputations and, *a fortiori*, to maintain a reputation for quality service once it is established.³⁷

- In addition to the relevance of reputation to individual providers of services, suppliers in particular industries or sectors may have a *collective* interest in ensuring that, industry-wide, a reputation for high quality is maintained. Organizations sometimes seek to maintain high quality service provision across an industry or sector by what has been described in some economic work as ‘delegated exclusion’.³⁸ This refers to situations in which particular suppliers can be excluded from the market by virtue of the existence of authorisations or licensing arrangements which allow for the “striking off” of suppliers who do not perform at an appropriate standard. The development of self-regulatory bodies in various professions – notably medicine and the law – arguably demonstrate perceptions of the collective interest in the maintenance of particular quality standards. In economic terms, the rationale for maintaining such a collective reputation for quality is similar to that of the individual practitioner. In both cases, the reputation of the provider/sector can be expected to increase demand for the services supplied. In the collective regulation case, however, success (in establishing and maintaining reputations) can be expected to have much more immediate and significant expansionary effect on the market than the conduct of any one supplier acting alone.

The relative importance of price and quality

96. A second related characteristic of the demand for legal services considered as economic products concerns the relative importance that consumers place on price relative to the quality of services provided. We have already noted that because legal service transactions often involve matters that which are of high importance for the consumer, this may have the effect, in some cases, of making consumers less sensitive to price. The suggestion that price is of relatively less importance than other factors, such as the skill of the practitioner, when consumers are choosing legal service providers is, for example, a point that has been raised in connection with the results of surveys of consumer behavior in some EU member states.³⁹

³⁷ We say ‘*a fortiori*’ because a reputation can take a considerable period of time to establish, and may involve incurring substantial costs before the full benefits start to flow. It is, however, a matter of simple observation that reputation can be lost quickly – one, highly publicised failure may be enough – and the cost-benefit trade-off can therefore become highly skewed: in any one year the costs of taking steps to maintain quality and reputation may be much smaller than the consequential damage if reputation is lost.

³⁸ J Tirole (1996) ‘A theory of collective reputations (with applications to the persistence of corruption and to firm quality)’ 63 *The Review of Economic Studies* p 1.

³⁹ Copenhagen Economics, *op cit*, page 22.

97. To the extent to which the proposition that consumers are relatively insensitive to the price of legal services is empirically verified – and we can offer no new evidence on this point here – this is sometimes seen to have implications for the nature of competition in legal service provision. For example, it is sometimes argued that price is not a significant factor for consumers when choosing a lawyer, and that lawyers therefore compete on the basis of quality rather than prices.⁴⁰ We think that this point can easily be overstated, however, as it has been in other, ‘non-commodity’ markets. In particular it would be wrong, on the basis of available evidence, to conclude that lawyers do not compete on prices at all. As noted above, price and quality can be closely associated, and in well functioning markets the price that a service provider can charge is often related to the quality of service provided. (i.e.: higher quality providers can charge higher prices, reflecting their skills).
98. Whilst differences in quality may account for much of the variation in prices that different service providers can charge customers for legal services, this does not imply the absence of variation in prices that are charged by service providers of *a given level of quality*. For example, we understand it is not uncommon to observe large multinational legal practices engaging in bidding competitions for contracts for the legal work of large corporate or government clients. At the other end of the scale, the notion that demand from non-business clients is insensitive to price is inconsistent with the view that demand for legal services is limited by considerations of affordability (a lower price obviously makes the service more affordable).

Mechanisms of redress for poor quality

99. A third general characteristic of the demand for legal services, and one which distinguishes it from the demand for other professional services and products, concerns the mechanisms available to consumers who are dissatisfied with the quality or performance of the provider. While an obvious potential port of call for consumers dissatisfied with the provision of an important non-legal service is a lawyer who can advise on potential avenues of redress, recourse to a lawyer regarding the legal services of another lawyer can create conflicts of interest,⁴¹ or, at least perceptions of such. If a profession is perceived as a ‘closed shop’ which ‘looks after its own’ when redress is sought (whether for poor quality of service through civil proceedings or for violations of professional rules through disciplinary proceedings), consumers may have reduced confidence in the legal services market, with consequent impacts on the level of transactions/ activity in that market. We note that, in some

⁴⁰ Ibid, page 22.

⁴¹ Generally on governance arrangements see: PA Grout, I Jewitt and S Sonderegger (2007) ‘Governance Reform in Legal Service Markets’ CMPO Working Paper No. 07/170.

jurisdictions, concerns such as these have led to the creation of mechanisms such as legal ombudsmen, which give consumers an avenue of complaint and advice in relation to the provision of legal services that is specifically categorized as ‘independent’ (of those who provide the services).

100. In sum, a number of characteristics of the demand for legal services are important when assessing the operation and performance of the market. While some of these characteristics, such as asymmetric information conditions and the relative importance consumers place on quality *vis-à-vis* price, are not unique to the legal services sector and can be observed in other markets, these issues may, for the reasons described in this section, take on a particular complexion in the context of legal services provision.

4.3 General characteristics of the supply of legal services

101. It is standard practice in economic assessments of any sector or industry to focus on various indicators of the supply structure, such as: how concentrated the sector is; the composition of supply (large versus small providers); what barriers might exist to the entry or expansion in the sector; the nature and magnitude of underlying costs; and how prices are formed, among others. Given the purposes of this paper, and the data that would be required to undertake a full EU-wide assessment of these indicators, we reach no detailed conclusions on these matters here (although the following section provides some economic measures of the size of the EU legal services sector). Rather, we focus on characteristics of the supply structure in legal services that might be relevant to public policy in relation to the sector, including regulatory policy. Specifically, we focus on how lawyers have historically organised themselves, as well as the various rules, norms and practices that have been adopted across the profession, and which potentially affect the supply of legal services.

102. Like most other professions, an important feature of the supply structure in the legal services sector is the role traditionally played by professional associations. Numerous historical studies have emphasized that a reason for the development of such associations is ensuring the collective autonomy and independence of the legal profession; in particular, by insulating the profession from state power and from powerful interest groups. Here we see a link with the points raised in section 2 of this paper in relation to the importance of legal independence and how this relates to the rule of law.

103. The discussion in the previous section also noted that self-regulating professional associations can play an important role in a transactional sense by

raising the quality standards of a profession, and in particular, by ensuring that all suppliers in the sector are suitably qualified and conduct themselves in an appropriate manner. To effect this, professional associations in the legal services sector have typically introduced various rules, norms and standards relating to entry into the profession⁴² and to acceptable conduct for those within the profession.

104. While the purposes and origins of these rules, norms and standards vary across different EU member states, reflecting, in part, different legal traditions, from an economic perspective the critical question concerns the effects these various rules/standards have on the structure of supply in the relevant markets. From an economic perspective such formal rules and informal practices can potentially have both beneficial effects on economic welfare (for example, by increasing the collective level of quality and weeding out unethical or poorly skilled practitioners, both of which, as we have said, increase confidence in the market and tend to expand it), and also adverse effects on economic welfare (by unduly restricting entry into a profession, or by limiting competition or innovation). In a sense therefore, it is an *empirical* question being asked when considering which restrictions/practices might have the effect of increasing quality in the supply of legal services and consumer confidence, and which (through being unnecessary or disproportionate) might increase costs, raise prices, limit consumer choice and have longer-term detrimental effects on innovation. We emphasise here that what is required is an *effects analysis*, not a formalistic inspection of the relevant rules.

105. Accordingly, it is necessary to examine the ‘rule book’ that is applied by the relevant professional association, and consider how the specific formal rules or informal practices might affect the supply of legal services, and therefore economic welfare. In the discussion that follows we examine some of the general types of rules or informal practices that are, or were until relatively recently, a common feature of legal professional associations. We then examine how each might affect legal services markets.

Entry in the profession

106. A characteristic feature of professions generally is the existence of a set of rules and standards about who is able to enter, and practise within, the profession. The legal services profession is no exception in this regard, and across all EU member states there are rules and requirements relating to who

⁴² We note that in many, but not all, EU member states the entry rules for the profession are set out in legislation. In these jurisdictions, professional associations can be expected to play a role in influencing the legislative provisions, but they are not themselves determinative in establishing entry/practice rules.

is able to practise. In general terms, these rules relate to specifying the necessary skills of the applicant (such as a need to satisfy certain minimum levels of educational attainment, to pass a test or professional examination or requirements in relation to minimum training and experience) and/or are based on various requirements associated with the character of the applicant (such as that the applicant not have a criminal record, or should satisfy other ethical tests/standards). In some cases a simple quota or restriction could be placed on the number of lawyers who are admitted to practise in a specific area of law.

107. The supporting reasoning behind the imposition of entry restrictions is usually heavily based on the promotion of quality in legal services, particularly in the context of asymmetric information conditions. In short, it is argued that entry standards, like on-going conduct and ethical requirements, establish and maintain certain collective standards of quality in legal services provision, which, as discussed earlier, serve to increase economic welfare by tending to expand the level of market activity.

108. On the other hand, the ability of suppliers to freely enter areas of economic activity (i.e. not face undue restrictions or barriers) is one of the most important components of a well-functioning market economy. For this reason, economists tend to be naturally suspicious of restrictions that are placed on entry either by professional associations or by existing suppliers in an industry. In the context of legal services this concern manifests itself in the view that entry restrictions could be designed inappropriately and could be used as a method for limiting the number of suppliers (lawyers), producing a tendency toward unduly high prices of legal services supplied to end consumers. The greatest suspicion inevitably falls upon quota restrictions, since these are not directly linked to quality of service, but concerns also exist in relation to training or qualification requirements which have the potential to be set at an unnecessarily high level for a specific area of legal practice.

109. This last point brings us to a specific form of entry restriction that applies in some jurisdictions, which involves the granting of exclusive rights to certain members of the legal profession. This can include the granting of exclusive rights to particular titles, such as ‘barrister’ or ‘solicitor’ in the UK and Ireland, or the granting of exclusive rights to practice in specific areas of the law. For example, in some jurisdictions an exclusive right is granted to practice in probate, in notarial activities and in areas such as immigration law or claims management. While rules relating to exclusive rights appear to be a function of the historical development of the legal system in different jurisdictions, it has been argued that the underlying rationale for such exclusive rights is, once again, the maintenance of high quality supply in specific areas. It has been suggested, for example, that imposing restrictions on who can provide services in court (i.e.: barristers) can result in better

advocacy, produce more valuable precedent and potentially lead to the more efficient operation of the court system.⁴³ As in the above discussion of more general entry requirements for the legal profession, the principal economic concern with exclusive rights is that they can provide a mechanism to artificially restrict supply, which can result in prices rising above an efficient level, or in quality degradation because of the reduction in competitive threat and challenge from other suppliers.

110. Given these points, in designing entry rules a balance has to be struck between the potentially positive economic benefits associated with rules that ensure services are provided only by appropriately skilled and ethical practitioners, and the potential negative economic effects where entry requirements are set too strictly,⁴⁴ and in consequence act partly as a barrier to entry by otherwise suitably skilled and qualified suppliers. That this is a complex balancing exercise is suggested by the fact that the design and implementation of professional entry requirements for the legal profession are subject to continual review in some jurisdictions.

Rules relating to price setting

111. Historically professional associations of lawyers have issued rules or guidance as to how their members set prices for specific legal services. These collective fee-setting arrangements have taken various forms in practice, including: mandatory fixed fees; minimum fee restrictions; maximum price recommendations; and schedules of recommended fees. A range of arguments has been used to support these collective fee-setting arrangements. Minimum prices have been said to be directed at maintaining service quality, by preventing low-quality firms undercutting higher quality providers; an outcome considered particularly adverse in the context of asymmetric information conditions and where consumers are not able to adequately assess product quality. Maximum prices or recommended prices are sometimes also argued to assist in addressing problems of asymmetric information, by restricting the ability of suppliers to exploit any information advantages they may have over consumers (by setting a price unduly inflated for the specific service provided).

112. Collective fee setting arrangements, especially those that set minimum or fixed prices, are generally viewed with suspicion by economists when they are applied in other sectors of the economy without compelling reasons or

⁴³ See, for example, the discussion in W Bishop (1989), 'Regulating the Market for Legal Services in England: Enforced Separation of Function and Restrictions on Forms of Enterprise' 52 *Modern Law Review* p. 326.

⁴⁴ For example, where there are tight quantitative restrictions on the numbers of practitioners allowed to practice in particular areas of law. See the discussion in paragraph 199-200 below.

other efficiency justifications. We can see no *a priori* reason why the effects of such collective fee setting arrangements by professional associations in the supply of legal services should be exempt from this standard economic suspicion. The underlying concern in relation to such co-ordination of prices is that there will be adverse effects on competition, resulting in higher consumer prices without any associated efficiency justifications. Reflecting these concerns, such rules and practices by professional associations relating to collective fee setting are now significantly limited by the application of competition law.

113. In some jurisdictions, such as Germany, certain legal fees are fixed or established in statute, and in such cases the required economic assessment is necessarily somewhat different, since it is a public authority, rather than potentially self interested suppliers, that determines the relevant prices. Traditional suspicions of economists about public price/fee setting may persist, for sometimes conflicting reasons. For example, there may be concerns that (a) fees are set at too high a level because of the partial ‘capture’ of the legislative process by suppliers, or that (b) fees are set too low because of wider political pressures to ‘keep prices down’, leading to reduced supply of services in the longer run. On the other hand, statutory fee scales may serve positive purposes such as (i) promoting access to justice via fee structures that favour those who might otherwise not be able to afford legal assistance, (ii) promoting the development of legal insurance services by facilitating the assessment of legal cost liabilities, and (iii) putting downward pressure on legal costs, without going so far as to discourage longer-term supply.⁴⁵ In relation to this last point, we note that, with issues of cost escalation very much in mind, in his review of civil litigation costs in the UK, Lord Justice Jackson closely examined the German approach, and, having been impressed with its effectiveness, one of the major recommendations of the Review was the introduction of a ‘fixed costs’ approach to certain aspects of litigation in the UK.⁴⁶

Advertising restrictions

⁴⁵ There are a number of complex issues surrounding legal cost inflation which lie beyond the scope of this current report. For example, increasing legal costs may be a result of higher levels of activity, caused for example by higher demand, which in turn may be promoted by a more litigious business culture, or by the growth in what has been called the ‘compensation culture’; and if higher demand is the cause, introducing direct measures to limit costs (rather than, say, measures to tackle any underlying problems that may be stimulating demand unnecessarily) might not be the best reaction.

⁴⁶ The Review recommended a ‘fixed costs’ approach for fast-track litigation (ie: value less than £25,000), and a dual system approach for other litigation cases whereby the costs are fixed for certain types of cases, and in other cases there is a financial limit on the costs recoverable (for example, £12,000 for pre-trial costs). Fixed costs are defined in that Report to embrace ‘(a) costs for which figures are specified and (b) costs which can be calculated by a predetermined means, such as a formulae in CPR 45’; See R Jackson ‘*Review of Civil Litigation Costs: Final Report*’ December 2009.

114. Professional associations sometimes place restrictions on the ability of lawyers to advertise their services. These rules have taken various forms in practice: from a total ban on advertising to limitations on the type of advertising (i.e.: no fee or comparative advertising) to restrictions on so-called ‘doorstop’ selling. The general argument in support of such restrictions is again related to service quality, and in particular, it has been claimed that such restrictions ensure uninformed consumers, or infrequent purchasers of legal services, are not persuaded into purchasing services which are inappropriate for their needs or of a poor quality.
115. Against this, it can be noted that advertising can potentially assist in addressing the problem of asymmetric information. In particular, it can assist in signalling quality of a particular service provider; provide relevant information that helps consumers in making more informed decisions; reduce consumer search costs; and provide a mechanism through which different suppliers seek to differentiate themselves from their competitors.
116. Although there is debate in the economic literature as to the effects of advertising on consumer behaviour and how this relates to economic welfare – including, in more recent work in behavioural economics, on ‘nudging’ – the standard economic position is one that views advertising as an important element of competition between suppliers in a market economy. Accordingly, blanket restrictions on advertising tend to be subject to a presumption that they will tend to soften competition among suppliers, which can result in adverse effects for consumers.
117. Of particular significance in debates on the effects of advertising is the impact of advertising on the intensity of price competition (as distinct from competition more generally). Whilst recognizing that this is ultimately a matter to be settled empirically, most economists tend to the view that, in many circumstances, higher advertising tends to soften price competition among firms, for example by helping to differentiate products/services and create ‘brand loyalty’. On this basis, banning advertising might be expected to increase price competition, even when it has the effect of reducing competition overall.
118. As in relation to fee setting, competition law nowadays constrains the ability of professional associations to restrict advertising by their members. The relevant constraints are not absolute, however, and certain specific restrictions on advertising are recognized as having potentially positive effects on consumer welfare, the most obvious of which are restrictions on advertising that is highly misleading. In the context of the legal profession there is also a case for at least some constraints on ‘negative comparative advertising’, whereby attention is drawn to performance failures of

competitors; since this could undermine trust and confidence in legal services providers generally, raise transactions costs, and reduce the level of market activity. Even here, however, there are trade-offs to consider⁴⁷, and it is difficult to see any convincing defence of more comprehensive or blanket bans on competitive advertising.

Rules on organisational and corporate structure

119. A common characteristic of the supply structure for legal services in many jurisdictions is that restrictions are applied to the forms of business structure and organisation through which lawyers provide their services. Commonly, these rules pertain to the nature of business structures that are permitted in the legal sector (including restrictions on lawyers and non-lawyers working in the same structure) and the form these business structures can take (such as limited liability partnerships). Rules also apply to the ability of law firms to attract external capital and financing (such as whether non-lawyers can own equity in a law firm or whether law firms can be listed on a stock exchange). These types of restrictions on business and organisational structure are at the centre of debates about so-called ‘alternative business structures’ (ABSs) in some EU jurisdictions, and also elsewhere. We consider some of the issues relating to ABSs in section 6 in more detail. For current purposes, we focus on how such rules might impact on the conditions of supply for legal services.

120. Restrictions on the business structures through which lawyers can practice are frequently justified on the basis that they ensure practitioners operate independently, and to required ethical and quality standards. In particular, such restrictions are argued to ensure that conflicts of interest⁴⁸ between a lawyer’s professional responsibilities (i.e. his/ her responsibilities as a lawyer) and his/her responsibilities to an organization not subject to such professional responsibilities do not arise. The perceived risk of such conflicts can potentially undermine consumer confidence in legal services, an outcome which, as discussed earlier, can be expected to have adverse effects on economic welfare.

121. On the other hand, rules relating to permissible business structures can have adverse economic effects in so far as they potentially restrict innovation.

⁴⁷ It may, in practice, be difficult to draw an enforceable dividing line between negative and non-negative advertising. Material that is ostensibly about the positive features of one legal practice may be designed in such a way as (implicitly) to draw attention to weaknesses in the performance of competitors, for example by making use of familiar, but unspoken, connections.

⁴⁸ Throughout this report we have defined ‘conflicts of interest’ broadly to capture issues relating to the independence and integrity of the legal profession. Thus, in the sense in which we are using the term, a conflict of interest can arise whenever a lawyer’s independence or integrity is challenged or compromised.

As discussed in section 6, this may be a particularly relevant issue in legal services as information technology comes to occupy a more important role in the professions as a whole. For example, there may be potential gains associated with closer links between lawyers and IT professionals. Similarly, allowing law firms to diversify their service offerings with other non-legal professional activities (such as multi-disciplinary partnerships) could be used as methods for managing risk, while allowing firms to attract external capital may allow firms to expand their activities to levels which they would otherwise not be able to reach.

122. There is a detailed body of economic work which examines the likely pros and cons associated with different forms of organisational and business structures, which dates back to the path breaking work of Ronald Coase on the Nature of the Firm (1937).⁴⁹ While this work provides a number of general insights, the crucial part of the relevant analysis tends to be highly context specific, and it does not provide any clear-cut or bright-line recommendations as to how different economic activities should be structured across industries. Under some conditions, it might be most efficient to combine different activities within a single firm or organisational structure, while in other conditions it may be more efficient to have the services undertaken by separate non-related entities. For this reason, the general position – and one which we would endorse in principle – is that the most appropriate form of organisational structure is the one that emerges through a process of competition. In this context, *ex ante* rules that prohibit the development of certain types of organisational and business structures restrict the ability of suppliers to compete on the basis of different forms of organizational structure, and from an economic point of view, must generally be viewed with some suspicion.

123. While we support this general presumption on questions of business structure, this does not mean that we think that the presumption is right in all circumstances. For example, the UK is currently in the process of imposing certain structural restrictions on the organization of banking, on the basis of arguments that are not wholly dissimilar to those that have been used to justify restraints on business structures in the provision of legal services (which ultimately rest on conflict of interest considerations). The relevant question is therefore whether the potential conflict of interest issues in legal services are such as to warrant particular types of restriction on business organization; and we note that, at bottom, this is a question that can only be settled on the basis of available evidence, not on the basis of abstract theorizing.

⁴⁹ R Coase (1937). "The Nature of the Firm" *Economica* 3, page 386.

124. For this reason, then, it is appropriate to reject the general proposition made by some commentators that the restrictions on business and organisational structures in the legal profession are clearly *always* anti-competitive.⁵⁰ Rather, economic assessment of the effects of organisational and business structure rules can only be made after careful analysis of the specific detail of the factual context (a view which is consistent with our general position on the assessment of the various rules and customs that affect the supply of legal services). As we discuss in section 6, this means that economic assessment of the rules relating to restrictions on different forms of business structures must encompass questions of independence, conflicts of interest and ethics in the context of legal services provision.

Conduct requirements

125. A further characteristic of the legal profession, and one that distinguishes it from some, but not all, other professions is the need for suppliers of legal services to conduct their activities and themselves in ways which accord with the general ethical principles of the profession. For example, conduct rules may extend to cover independence, legal professional privilege, confidentiality and dealing with conflicts of interests in a narrower, legal sense. Where lawyers' conduct is found to be of an inappropriate standard, various disciplinary measures can take effect, including: warnings, reprimands, fines or in some cases disbarment. While disbarment is obviously the most severe form of remedy, the other measures can also have a significant adverse impact on the reputation of a lawyer. Moreover, the very existence of such a system of disciplinary measures, particularly where it is highly visible, tends to promote confidence and trust on the part of consumers, and to have the general effect of all confidence- and trust-building market features, namely to reduce transactions costs.

126. Requirements that practising professionals maintain particular ethical standards are not unique to law, but they arguably take on a special importance in the context of legal services, given the frequently sensitive and confidential nature of the services provided, and the strong links between legal practice and the institutional fabrics of market economies. We note that a distinct issue here, and one which has been the subject of considerable debate in the EU context, is how to resolve differences between conduct standards where individual lawyers practice law in jurisdictions other than those in which they are admitted. There appear to be some differences across EU member states in the specific conduct requirements placed on practising

⁵⁰ See, for example, R van den Bergh (2007) 'Towards better regulation of the legal professions' Background Paper in *Competitive Restrictions in Legal Professions* OECD Policy Roundtable, p 49.

lawyers. In some cases, these requirements may reflect customs and practices intimately linked with the historical legal tradition in that jurisdiction.

127. In general terms, conduct requirements are closely linked to issues of quality of service and to issues of consumer confidence in suppliers. As with the other rules or requirements which govern the activities of lawyers discussed in this section, and which ultimately affect the structure of supply for legal services, in some circumstances specific conduct requirements can have potentially restrictive effects on the supply of legal services. For example, onerous ethical provisions may make practitioners reluctant to provide particular types of advice to customers even in circumstances where there is no apparent conflict of interest. As with rules relating to entry to the profession, getting the right balance when designing conduct rules is a difficult area and one which raises a range of moral, social and economic issues.

128. In sum, the structure of the supply of legal services gives rise to a number of specific economic issues which can have important implications for the degree of competition in the legal services market, and on economic welfare more broadly. In particular, a range of professional rules or restrictions govern the provision of legal services. While these differ in substance and scope across the EU member states, the general categories of rules relate to entry requirements, price setting, advertising and the conduct of legal professionals, as well as rules relating to permissible forms of business structures and organisations. The general justification for such restrictions is that they ensure quality and integrity in service provision, which maintains consumer confidence in the legal services market, and are therefore market expanding. At the same time, such rules have the potential to have adverse effects on economic welfare through reduced competition, higher prices and the stifling of innovation. In these circumstances, any assessment of the legal services market needs to consider the various formal rules (whether statutory or established by professional associations) or informal practices individually in determining how each might affect the supply of legal services, the confidence that consumers have in the legal profession, and economic welfare.

4.4 Summary

129. The discussion in this section has focused on the attributes of the legal services sector at the transactional level, including the different types of services that are supplied, the general characteristics of demand for those services, the supply of legal services, and the ways in which the services may differ from other professional services.

130. These general attributes are of relevance when considering different regulatory and public policies for the sector. While some of the characteristics of demand and supply in legal services are common to other areas of economic activity, including conditions of information asymmetry and potential issues associated with training and qualification requirements, these characteristics may serve specific purposes in the legal services context.
131. Our main conclusion is an old one, and it should be non-controversial: context matters, and good regulation is reflective of the relevant context. More generally, it is one of the most important features of adaptive, well functioning market economies that the particular ‘rule-books’ (i.e. institutions) governing economic conduct, whether formal or informal or some mixture of the two, develop to reflect the challenges of the relevant context to which they apply. Prospective changes to the ‘rule-books’/institutions need, therefore, to be evaluated on their merits, in their specific contexts. The ‘rule-books’ that govern legal service provision are no exception.

5: ASSESSING THE CONTRIBUTION OF THE LEGAL SERVICES SECTOR TO THE EU ECONOMY

132. It should be evident from the preceding discussions, particularly those concerning the non-transactional effects of the activities of lawyers, that it is an impossible task to quantify, with any degree of accuracy, the overall contribution of the legal services sector to the EU economy. A measure such as the share of GDP, or value added accounted for by legal services, provides an indication of the value of resources used up in the ‘production’ of such services, but such estimates are always open to challenge even when used for the more limited purpose of assessing immediate and direct contributions to GDP. For example, those who take the view that lawyers are over-paid can argue that the measured contribution contains significant economic rents.⁵¹
133. Notwithstanding these difficulties, various studies have sought to quantify and assess the economic impacts of the legal services sector on economic performance. The approach adopted in some economic studies has been to identify a number of high-level statistics or indices of the characteristics of the legal services profession in different countries (such as the number of lawyers, or law firms). Such indices are then used as the basis for drawing comparisons between the legal services sector and other professions in the economy (ranging from pharmacy and dentistry to tourism services).
134. An alternative approach has been to apply various statistical and econometric techniques to indicators of the structure of the legal services sector. In particular, some studies attempt to examine the relationship between the level of ‘restrictions’ in the legal sector and various economic indicators (such as productivity, employment, turnover and firm size). Another type of econometric model approaches the issue by attempting to assess the ‘optimum’ number of layers in an economy, and draw conclusions about whether there are too many or too few lawyers in a given jurisdiction.
135. Our general view of these attempts to quantify the economic impacts of the legal services sector on economic performance is that, while they have provided some high-level insights on certain issues and some new statistics, there are significant limitations attached to the work (which in some cases is recognized by the authors of the studies themselves). A problem common to all of the studies is the paucity of reliable and accurate data that have been

⁵¹ An economic rent is a payment to a factor of production (such as capital or labour) over and above that which is required to keep it its current employment.

collected in a consistent manner across different EU member states and over time. For this reason alone we would suggest that the results of these quantification exercises be approached with caution. At best, we are of the opinion that existing studies of the economic impacts of the legal services sector should only be used as a basis for a very general assessment of the economic contribution of the sector. We develop our reasons for this opinion in the discussion that follows, but two broad criticisms can be identified at the outset.

- Many studies lack a clearly defined hypothesis to be tested against another hypothesis or counterfactual. For example, one study focuses on the relationship between indicators of the ‘restrictions’ applying to practitioners in a profession and indicators such as firm size or employment. However, as the study itself openly acknowledges, although empirical relationships among variables can show some degree of association, they do not tell us anything about causality. More fundamentally, the limitation of this type of approach is that, being limited to looking at factors for which consistent statistics are easily available (which tend to be very few in number), it fails to account for many of the other factors that are almost invariably affecting any association between the measured variables. However ‘scientific’ the methodologies of these studies may look, they tend to suffer from a common, critical defect: they ignore (abstract from) highly relevant information and evidence. If it were possible to conduct the equivalent of judicial review on econometric studies, they would, whenever they seek to address context-specific issues such as rule-books and institutions, tend to fail comprehensively, unless used only as adjuncts to rather broader types of ‘effects’ analysis.
- A limitation common to all of the studies is that they focus on the economic contribution of legal services only in a direct ‘value-added’ sense. For example, the measures of the contribution of the legal services sector as a proportion of GDP are typically based on the total revenues earned in the sector. Even at best (assuming the GDP contribution is a meaningful measure, which is itself problematic), such estimates necessarily fail to capture the significance of the legal services sector in facilitating other sorts of business transactions, which are points we discussed in section 3 above. The underlying flaw is once again a tendency toward over-abstraction and the neglect of relevant information and evidence.

136. These general points serve as a health warning and, having made them, we proceed in this section to present and discuss some of the statistical and

quantitative estimates that have and can be made of the direct, value-added contribution of the legal services sector to the European economy.

5.1 Statistical estimates

137. At a global level, the legal services market has experienced sustained growth over the past decade as a result of an increase in international trade and greater economic links between countries, as well as growth in developing economies, all of which has led to an increase in demand for legal services. The World Trade Organization (WTO), estimated that total revenues in the global market for legal services at \$581 USD billion in 2008, and that this represented a growth of 5% annually since 2004.⁵² The 2008 figure is equivalent to just under 1% of global GDP in that year.⁵³ In terms of the geographic distribution of the revenues associated with legal services, the WTO analysis suggests that legal services in Europe accounted for approximately 36.5% of the global legal services market by value in 2008, with the US share of the global legal services market estimated at 54.1% and the share of the Asia-Pacific region being 9.4%.⁵⁴

138. Against this general background of global growth in the legal services sector, we now turn to examine different statistical estimates of the composition, size and values of legal services sector in Europe and in specific Member States.

Number of lawyers

139. At the European level, and in most Member States, there has been a significant increase in the number of legal services practitioners during the period 2006-10. Table 1 below shows that in 2010, the number of legal professionals in Europe was estimated at just over 1 million, representing an increase of approximately 10% (or 94,000 lawyers) over the number of lawyers in 2006.⁵⁵ By way of comparison, in 2010, there were an estimated 1.2 million lawyers in the United States.⁵⁶

⁵² World Trade Organization (2010) 'Legal Services' Background Note Prepared by Secretariat, page 1.

⁵³ Based on \$581/\$61290 (USD Billion). Data sourced from World Trade Organization (2010) (page 1), and World Bank on GDP in current dollars 2008.

⁵⁴ These figures are based on proxies from the largest regional markets, and do not account for the figures for the Middle East and Africa.

⁵⁵ This data is based on material provided in Datamonitor (2011) *Legal Services in Europe*. However, note the definition of Europe is wider than that of the EU Member States and includes Norway, Switzerland, Turkey and Russia and the Ukraine.

⁵⁶ ABA Market Research Department, National Lawyer Population by State 2002-2012.

Table 1: Number of Legal Professionals in Europe, 2006-10

	Number of lawyers	(% Change)
2006	936,200	
2007	964,100	3.0%
2008	985,300	2.2%
2009	1,002,400	1.7%
2010	1,030,200	2.8%
Change (%) 2006-10	94,000	10%

Source: Datamonitor

140. The growth in the number of legal professionals is expected to increase steadily over the period to 2015, and as shown in table 2, it is estimated that between 2010 to 2015 an additional 145,000 legal professionals will begin to practice in Europe (representing a growth rate of 14%). By 2015, it is expected that there will be some 1.175 million lawyers across Europe (although note that these estimates include non-EU countries such as Russia, Turkey and the Ukraine).

Table 2: Forecast number of Legal Professionals in Europe, 2010-15

	Number of lawyers	(% Change)
2010	1,030,200	
2011	1,053,200	2.2%
2012	1,082,600	2.8%
2013	1,114,000	2.9%
2014	1,144,700	2.8%
2015	1,175,200	2.7%
Change (%) 2010-15	145,000	14%

Source: Datamonitor

Number of lawyers per capita

141. Given the observed variation in the total number of lawyers across the different EU member states, it is perhaps unsurprising that the proportion of lawyers per capita in each member state varies significantly. Specifically, as shown in table 3, based on 2008 estimates the number of lawyers per capita ranges from a low of 0.47 lawyers per 1000 head of population in Lithuania to 4.05 lawyers per 1000 head in Liechtenstein. At the European level, there was an average of 1.81 lawyers per 1000 head of population in 2008. By way of comparison in 2008, in the United States, there was an estimated 3.82 lawyers per 1000 head of population.

Table 3: Lawyers per 1000 population, 2008

	2008	Pop 2008	Lawyers per 1000 population (2008)
Austria	5,129	8,355,260	0.61
Belgium	15,363	10,754,530	1.43
Bulgaria	11,511	7,606,550	1.51
Cyprus	1,781	793,960	2.24
Czech Republic	8,020	10,467,540	0.77
Denmark	5,246	5,511,450	0.95
Estonia	676	1,340,420	0.50
Finland	1,810	5,326,310	0.34
France	47,765 ²	64,351,000	0.74
Germany	146,910	82,050,000	1.79
Greece	38,000	11,257,290	3.38
Hungary	9,934	10,031,210	0.99
Iceland	774	319,370	2.42
Ireland ¹	9,346	4,465,540	2.09
Italy	213,081	60,053,440	3.55
Latvia	1,091	2,261,290	0.48
Liechtenstein	144	35,590	4.05
Lithuania	1,590	3,349,870	0.47
Luxembourg	1,318	493,500	2.67
Malta	393	413,630	0.95
The Netherlands	14,882	16,486,590	0.90
Norway	5,390	4,799,250	1.12
Poland	34,181	38,135,880	0.90
Portugal	25,695	10,627,250	2.42
Romania	16,998	21,498,620	0.79
Slovak Republic	4,595	5,412,250	0.85
Slovenia	1,153	2,032,360	0.57
Spain	154,953	45,828,170	3.38
Sweden	4,503	9,256,350	0.49
Switzerland	8,321	7,700,200	1.08
United Kingdom	139,789	61,634,600	2.27
Total Europe	930,342	512,649,270	1.81
<i>Total USA</i>	<i>1,162,124</i>	<i>304,059,724</i>	<i>3.82</i>

1. Because of gaps in data collected in 2008, we have used the CCBE estimate of lawyers in Ireland in 2010 of 9,346.

2. We are informed that this reported figure relates to 2007, not 2008.

Sources: CCBE; Eurostat; American Bar Association, Market Research Department 6/2008; United States Census Bureau.

Number of legal enterprises

142. Information collected by Eurostat covers the number of legal enterprises operating in Europe and suggests that, in 2009, there were in excess of 492,000 legal enterprises in the 27 EU member states.⁵⁷ This number of legal enterprises had increased by just over 4% since 2008. (Table 4)

Table 4: Number of legal enterprises, 2008 and 2009

	2008	2009	% Change 2008-09
Italy	145,501	147,713	1.5%
Spain	99,533	94,749	-4.8%
France	51,646	48,975	-5.2%
Germany	46,580	48,326	3.7%
United Kingdom	29,093	28,940	-0.5%
Portugal	25,862	26,176	1.2%
Poland	15,625	20,988	34.3%
Czech Republic	9,736	10,095	3.7%
Netherlands	8,063	8,548	6.0%
Hungary	8,282	7,628	-7.9%
Belgium	4,853	5,650	16.4%
Sweden	5,230	5,284	1.0%
Austria	4,676	4,846	3.6%
Ireland	3,946	4,242	7.5%
Croatia	3,451	3,967	15.0%
Lithuania	2,830	2,785	-1.6%
Norway	2,440	2,422	-0.7%
Switzerland	n/a	2,242	n/a
Latvia	1,938	2,148	10.8%
Finland	1,607	1,605	-0.1%
Slovenia	1,427	1,502	5.3%
Luxembourg	1,248	1,377	10.3%
Bulgaria	913	1,167	27.8%
Estonia	580	558	-3.8%

⁵⁷ According to the Eurostat definition “legal services cover the activities of advocates, barristers, solicitors, notaries, registered lawyers and legal consultants. Enterprises in this sector are generally small, and a common legal form is that of partnerships”. Moreover, Eurostat defines an enterprise as “the smallest combination of legally recognised units constituting an organisational unit for producing goods or services; benefiting from a certain degree of autonomy in decision making, especially for the allocation of its current resources. It may be a sole legal unit and carries out one or more activities at one or more locations.”

<http://epp.eurostat.ec.europa.eu/statistics_explained/index.php/Legal,_accounting,_market_research_and_consultancy_services_statistics>

Cyprus	661	552	-16.5%
Romania	524	331	-36.8%
Slovakia	191	241	26.2%
Denmark	1,608	n/a	n/a
Greece	n/a	n/a	n/a
European Union (27 countries)	472,870	492,341	4.1%

Source: Eurostat: Number of Legal Enterprises (NACE Rev.2)

143. Although statistics are not available on the movement of law firms across Europe, we note that the WTO report referred to earlier cites a study which estimates that over 50% of the revenue of the largest 100 law firms is generated by international firms based in London (either US, other European or Australian firms).⁵⁸ This study suggests that these law firms have developed into an almost full-service capability in respect of English law. The WTO also refers to another study which makes the observation that although many foreign law firms opened offices in Brussels to practice EU law, in some cases they have diversified into the practice of Belgian commercial law.

Value of legal services market

144. The estimated value of the legal services market in Europe, as measured by the total revenues received by law firms, was €113.6 billion in 2010.⁵⁹ Table 5 shows that the total revenues increased by an estimated 10% (or €10.4 billion) over the five-year period 2005-2010. During that time the annual growth reduced slightly only in 2008 and 2009, perhaps reflecting the effects of the financial crisis. However, during 2009 and 2010 the market began to grow again, and according to some estimates this growth in the value of legal services market is expected to increase and accelerate. By 2015, some commentators have estimated the size of the European market at €148.2 billion, representing a growth rate of over 25% over the 2010 estimates of the size of the market (table 6).

⁵⁸ World Trade Organization (2010) 'Legal Services' Background Note Prepared by Secretariat, page 5.

⁵⁹ Note again that this data is based on material provided in Datamonitor, and the definition of Europe is wider than that of the EU Member States and includes Norway, Switzerland, Turkey and Russia and the Ukraine.

Table 5: Value of legal services market in Europe, 2006-10

	Value of market (€ Billion)	(% Change)
2006	103.20	
2007	107.90	5%
2008	109.90	2%
2009	109.60	0%
2010	113.60	4%
<i>Change (%) 2006-10</i>	<i>10.40</i>	<i>10%</i>

Source: Datamonitor

Table 6: Forecast value of legal services market in Europe, 2010-15

	Value of market (€ Billion)	(% Change)
2010	113.60	
2011	119.40	5.1%
2012	124.80	4.5%
2013	130.60	4.6%
2014	136.50	4.5%
2015	142.80	4.6%
<i>Change (%) 2010-15</i>	<i>29.20</i>	<i>26%</i>

Source: Datamonitor

145. The value of legal services for the five biggest European countries as measured by total revenue is shown in table 7. This table suggests that in 2010, the UK had the largest share of the European legal services market accounting for some 26% of total European revenues. This was followed by Germany, which accounted for some 22% of total revenue, and Italy, which accounted for 16% of total revenue. In total then, the UK and German legal services markets accounted for just under 50% of the total revenues of the legal services sector in Europe.

Table 7: Value of legal services market in Europe, selected countries, 2010

	Value (% share)
United Kingdom	26%
Germany	22%
Italy	16%
Spain	10%
France	10%
Rest of Europe	16%
Total	100%

Source: Datamonitor

Average revenue per lawyer

146. In terms of average revenue per lawyer (ARPL) – which is measured by turnover or fees per lawyer – table 8 below shows that, at the European level, the ARPL was estimated at €110,270 in 2010, which was generally the same as the ARPL estimate for 2005. Some commentators expect that the growth in the European legal services market will lead to a higher ARPL in the future, and by 2015 it is estimated that the ARPL will increase to €121,511 (representing an increase of just over 10%).

Table 8: Average revenue per lawyer, 2006-10

	Average revenue per lawyer (€)
2006	110,233
2007	111,918
2008	111,540
2009	109,338
2010	110,270
<i>Average 2006-10</i>	<i>110,660</i>
2011	113,369
2012	115,278
2013	117,235
2014	119,245
2015	121,511
<i>Average 2010-15</i>	<i>117,328</i>

Source: Datamonitor and Regulatory Policy Institute

147. The ARPL varies across different EU member states. In the UK and France, for example, the ARPL in 2010 was estimated at above €210,000, which is considerably above the average.⁶⁰ While in Italy and Spain the ARPL is estimated at €83,000 and €72,000 respectively, which reflects the relatively higher number of lawyers per capita in those countries.⁶¹

⁶⁰ The UK estimate is based on the number of lawyers in 2008 as shown in table 3.

⁶¹ The Italian estimate is based on the number of lawyers in 2008 as shown in table 3.

Table 9: Average revenue per lawyer, selected countries 2010.

	Average revenue per lawyer (€)
United Kingdom*	212,915
Germany	165,303
Italy*	83,702
Spain	72,233
France	216,751

* Number of lawyers based on 2008 estimates.

Source: Datamonitor (for revenue data); CCBE (for number of lawyers data) and Regulatory Policy Institute.

Note: Average revenue is measured by turnover or fees per lawyer. The average revenue per lawyer has been calculated using a combination of these data sources – CCBE for the number of lawyers, and Datamonitor for the revenue data. To the extent that there are anomalies in this analysis (and the figure for France may be one such – we understand that INSEE data indicate an average income across all legal professionals of around €90,000, which on a normal turnover to income ratio of 2, would suggest an average revenue figure much closer to that for Germany), this almost certainly reflects the wider problems associated with obtaining consistent and reliable cross-country data in this area, as discussed in paragraphs 132 to 135 above.

Contribution to GDP

148. As noted above, in terms of the contribution of the legal services sector to GDP it is currently estimated that, at the global level, the contribution of the sector was just under 1% in 2008. It is not possible to accurately estimate an equivalent figure at the European level, however, table 10 below shows the contribution of legal services as a proportion of GDP in 2010 in the five largest European markets (based on estimates of total revenues). This table shows that the proportion of legal services total revenues to GDP varies from 0.6% in France to 1.8% in the United Kingdom. The combined proportion of legal services revenues for the five largest European markets is 1.1% of GDP.

Table 10: Value of legal services as a % of GDP, 2010 selected countries

	% of GDP	Number of lawyers per 1000
United Kingdom*	1.8%	2.27
Germany	1.0%	1.79
Italy*	1.2%	3.55
Spain	1.1%	3.38
France	0.6%	0.74
Total for five largest EU countries	1.1%	2.28
<i>United States of America (2007)</i>	<i>1.8%</i>	<i>3.82</i>

* Number of lawyers based on 2008 estimates.

Source: Datamonitor, CCBE, Eurostat, United States Census Bureau (Service Annual Survey 2007), World Bank and Regulatory Policy Institute;

149. Although for reasons already stated we are of the view that extreme care should be taken in relying on these estimates, we note that the estimates are broadly consistent with those presented in the study by the Institute of Higher Studies in Wien (IHS) prepared for DG Competition in 2003.⁶² In that study, the mean estimate of turnover as a proportion of GDP in the countries surveyed was 1.18%.⁶³ They are also broadly consistent with estimates of the contribution of the legal services sector to the US economy, which was estimated at approximately 1.8% in 2007. It is interesting to observe that while there are relatively similar levels of contribution to national GDP in the US and the UK, there is a relatively higher number of lawyers per capita in the US than in the UK.⁶⁴ This likely reflects differences in the structure of the profession between the two countries, with a much greater relative contribution from commercial work, including exports, in the UK.

150. While the statistics on legal services markets across Europe can provide interesting comparative insights into specific characteristics of different legal services markets, they are not explanatory of differences across jurisdictions. For example, the statistics show that Liechtenstein and Luxembourg have a relatively high number of lawyers per capita, which most likely reflects the relatively small population of these countries, and also the balance of their economies, rather than any tendencies towards an excess of lawyers in these jurisdictions. Similarly, where the statistics are used as the basis of comparison of the legal services sectors with other services sectors – such as accountancy or pharmacists – no account is made for differences across the profession. For example, the fact there may be more or less law firms than accounting firms in a particular country does not necessarily reveal anything about whether or not this ‘good’ or ‘bad’ in economic terms (that is, there is no *a priori* reason why having 100 firms or 50 firms should be considered better or worse for competition and other economic outcomes).

5.2 Econometric approaches

151. For all of the reasons noted above, there are, even at a preliminary level, formidable difficulties in quantifying the economic contribution or significance of the legal services sector in the EU. Moreover, these assessment

⁶² Institute for Advanced Studies (2003) “Economic impact of regulation in the field of liberal professions in different Member States” Report for European Commission DG Competition, page 97.

⁶³ The specific estimates for the UK, Germany, Italy, Spain and the France were 1.62%, 0.59%, 0.97%, 0.89% and 0.95% respectively in 2000. Ibid, page 97.

⁶⁴ The UK estimate is based on a turnover of €29.76 billion (26% of €113.6 billion) using Datamonitor estimates, divided by GDP of €1,697 (using Eurostat estimates).

problems multiply as more technical forms of analysis are applied to relevant issues. To take one example, the existing estimates of the transactional values of legal services are based on market prices, which in turn tend to reflect marginal valuations – the worth of a little bit more of the product or service in question. Marginal valuations may be very different from, and, in particular, much lower than, average valuations – the average worth of each unit of the product or service supplied – as is illustrated by the so-called ‘diamond water paradox’. The market price (marginal value) of a gram of water is considerably less than the market price of a gram of diamonds, but the *average* value to a consumer of a gram of water is nevertheless higher than the average value of a gram of diamonds. Whilst the latter part of this statement may appear strange at first sight, it reflects the simple fact that mankind can live satisfactorily without diamonds, but not without water.

152. There are also severe practical difficulties in measuring even the transactional values of legal services at market prices. ‘Legal services’ encompass a variety of different types of activity, each with its own characteristics and supply and demand conditions. Different jurisdictions tend to use differing definitions so that, particularly in wide-ranging international comparisons, like is not always compared with like, notwithstanding the best efforts of international agencies in trying to establish greater harmonisation in national statistics. Further, whilst the revenues of legal services firms provide a basis for measuring the value of output, not all lawyers work in such firms: many are employed directly by non-legal commercial enterprises, and by government at both local and central levels, and their value added will be captured as part of the value added of the employer, not as an identifiable legal service.

153. It is not always fully appreciated that econometrics exercises typically depend upon the availability of consistently constructed datasets, and that no matter how sophisticated the mathematical techniques may be, they cannot compensate for data inadequacies. Data problems, together with the fact that assessment of the many of the issues connected with the performance of the legal services sector can only properly be studied by taking into account a potentially wide range of different factors and pieces of evidence, therefore severely constrain what can safely be inferred from the relevant exercises.

The optimum number of lawyers debate

154. As an illustration of the challenges to quantification, consider one or two of the issues that have arisen in a long-running debate about the ‘optimum number of lawyers’ in the USA, where the population density of lawyers (i.e. the number of lawyers per head of the population) is substantially higher than in Europe. Table 11 below shows figures from circa the year 2000 that have

been used in one of the leading contributions to the US debate, and it can be noted immediately that the estimates of the number of lawyers per capita presented in this table are generally lower than the estimates presented in table 3. These differences reflect the fact that the data in the two tables are drawn from different sources, and in particular that the data in table 11 are for the year 2000, while table 3 is based on 2008 data.

Table 11: Number of lawyers per 1,000 population (circa 2000)⁶⁵

	Lawyers per capita (2000)
Austria	0.50
Belgium	1.23
Denmark	0.78
Finland	0.30
France	0.64
Germany	1.34
Greece	2.96
Ireland	2.09
Italy	2.33
Luxembourg	1.75
The Netherlands	0.69
Portugal	1.62
Spain	3.36
Sweden	0.41
United Kingdom	1.75
<i>Total Selected EU</i>	<i>1.65</i>
USA	3.65
Argentina	3.40
Canada	2.20
Australia	1.85
Mexico	1.82
Chile	1.26
Thailand	0.84
Turkey	0.75
South Africa	0.40
Nigeria	0.37
India	0.25
Japan	0.16

⁶⁵ It can be noted that there appear to be some inconsistencies between these data and numbers presented in earlier tables, drawn from different sources. These illustrate the general data problems that exist in this area, and serve as a further caution against uncritical interpretation of the results of econometric studies based upon national statistics: relationships that are derived using one dataset may appear rather different from those derived from an alternative dataset that is nominally trying to capture the same or similar information.

Source: Magee, SP (2010) “The optimum number of lawyers: and a radical proposal for legal change” Paper for conference at George Mason University, December 2010. Exhibit 1.

155. All parties in the US debate would likely recognise the positive contribution of lawyers to economic activity arising from the institutional effects discussed in the first two sections of this report, which are sometimes referred to as ‘facilitative effects’. However, the advocates of the ‘too many lawyers’ view argue that, in the USA, the scale of legal activity has expanded beyond the optimum level, because a substantial fraction of legal resources is now devoted to activity related to attempts to redistribute economic resources, which has negative consequences overall.
156. In economics, these redistributive activities are called ‘rent seeking’, and the harmful effects derive from two factors:
- resources are used up in the struggle for economic rents, and
 - the struggle itself creates distortions that impair wealth creation.
157. An example of the first of these effects is the economic cost of the legal resources used in litigation: Magee cites a Texas statistic to the effect that 80% of the malpractice lawsuits lodged against physicians come away with zero damages.⁶⁶ An example of the second effect is the restrictions on competition produced where market rules/regulations favour a particular interest group.
158. The US debate on the optimum number of lawyers has been closely associated with the policy debate on Tort law reform, which remains vigorous. Indeed the arguments surrounding radical legal reform indicate the economic complexities that necessarily need to be addressed before sensible conclusions can be reached concerning relevant trade-offs. Advocates of reform tend to argue that excessive, compensation-seeking litigation has a chilling effect on innovation, associated with fears that new products and new ways of doing things will, over time, be revealed to have harmful effects that will eventually give rise to liabilities that are unknown (and possibly) unknowable at the outset. Opponents of radical reform can, on the other hand, point to Tort law as a system for addressing what would otherwise become economic externalities, and hence would be potential sources of economic inefficiency: without the possibility of being required to pay compensation for harm caused to others, economic incentives would tend to encourage harm-creating activities. Products might be less safe, new medicines might not be adequately

⁶⁶ Magee, SP (2010) “The optimum number of lawyers: and a radical proposal for legal change” Paper for conference at George Mason University, December 2010. Exhibit 1.

tested, physicians might not exercise due care on behalf of their patients, employers might take fewer precautions to prevent accidents at work, manufacturers might cause greater pollution, and so on.

159. At a less elevated level of argument, critics of current arrangements in the US argue that they serve the interests of lawyers who, in the process of assisting their clients acquire a larger share of any available economic rents, are able to capture a significant fraction of available rents for themselves. On the other side of the debate, it is argued that Tort reform is promoted most vigorously by vested interests who seek to gain rents by avoiding having to pay compensation for harm that their activities have caused or might cause.

160. In the abstract, economic theory can identify the existence of an optimum structure of Tort law which would balance the beneficial effects of incentives on suppliers in relation to *ex ante* efforts to avoid harm with the negative effects of the associated *ex post* risks of non-avoidable harm and of the direct (legal) and indirect costs incurred in the process. Moving from this abstract description of the trade-offs to a quantitative assessment capable of informing an answer to the question *are there too many lawyers?* is, however, a major, empirical exercise. The scale of the exercise is greatly increased by the fact that the relative significances of the various counteracting factors can be expected to vary with context: there will be some circumstances where reducing exposure to damages litigation can be expected to improve outcomes, and other circumstances where it can be expected to have exactly the opposite effect.⁶⁷

161. Unfortunately, as already noted, the tendency of much economic work is to avoid this careful attention to contextual detail, and to work at a much higher level of aggregation or abstraction. Much of the debate on the optimum number of lawyers takes this latter approach, and in so doing tends to reduce its own capacity to contribute usefully to policy analysis.

162. Consider, for example, the argument that excessive legal activity has had a negative effect on US economic growth. In support of the argument, early contributions to the debate exhibited empirical relationships between international differences in GDP growth rates and legal density, measured (say) as the number of lawyers per thousand members of the relevant population. These relationships typically took the form illustrated in Figure 1 below.

⁶⁷ More generally, see R Coase (1960) 'The Problem of Social Cost' 3 *Journal of Law and Economics* pp.1-44.

163. The first thing to say about this relationship is that it implies that economic growth is maximised by having no lawyers. The absurdity of this result has subsequently led to refinements that claim a relationship of the form shown in Figure 4 (below), where there is a well-defined optimum level of activity. For the moment, however, our focus will remain on Figure 1.

164. In its empirical version, the relationship is constructed from a global cross-section of jurisdictions, including observations from countries with radically different institutional structures and at substantially different levels of economic development. Speaking broadly, in the modern period less developed countries have been growing faster than those countries that industrialized earlier (as shown in Figure 2). They also tend to have lower numbers of lawyers per head of population than higher income countries (as shown Figure 3).

Figure 1: Average growth and legal density

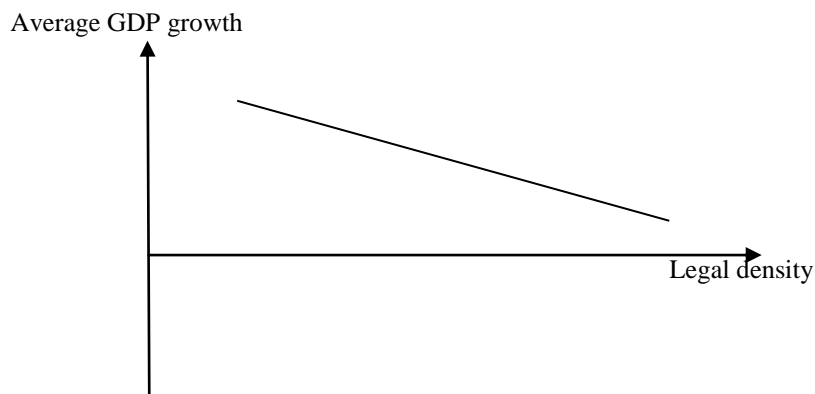


Figure 2: Average growth and GDP per capita

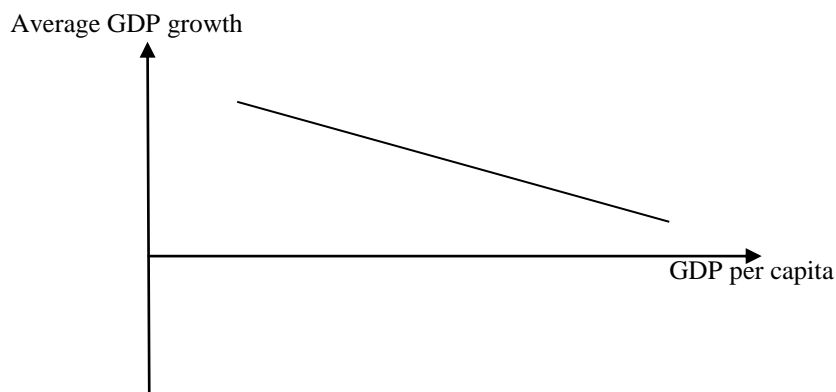
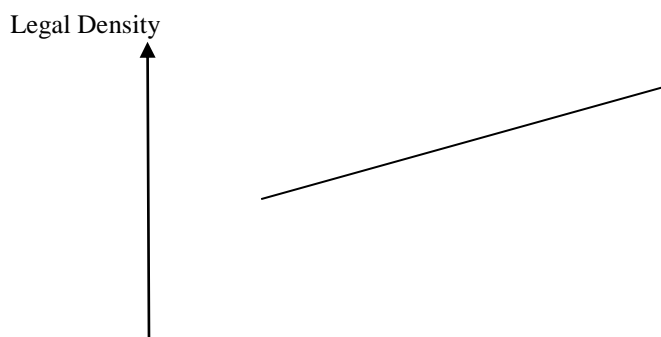


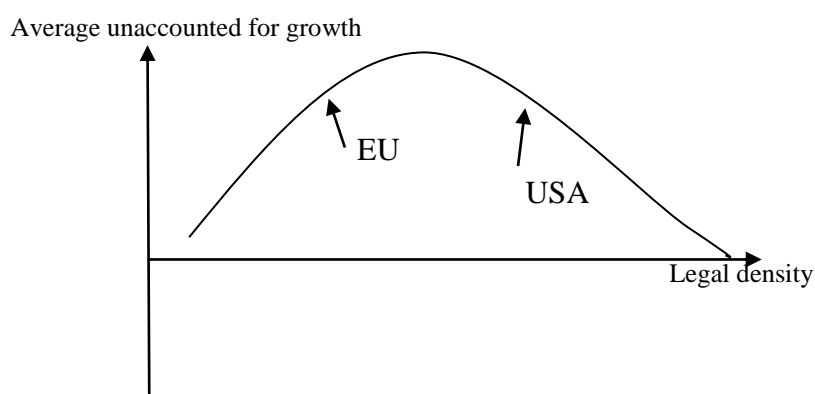
Figure 3: Legal Density and GDP per capita



165. Putting these two facts together leads to an expectation of the type of relationship shown in Figure 1: a low GDP per head country will tend to have both a higher average growth rate and a low legal density, and will therefore appear toward the left end of the line in Figure 1, whereas a high GDP country will tend to have a lower growth rate and a high legal density, and appear toward the right end of the line in Figure 1. A negative correlation between legal density and growth arises from a confounding factor, GDP per capita or the level of economic development of the jurisdiction. In the example given, the relationship in Figure 1 does not imply a causal connection between the two variables. This is, of course, a common and familiar problem in statistical analysis.
166. Later economic work on the issue is more sophisticated. Magee, for example, first seeks to account for international variations in growth rates and in legal densities in terms of a range of other factors and then examines the linkage between variations in growth rates that cannot be accounted for by these other confounding factors and legal densities. Although the methodology is open to challenge, he finds a relationship of the form shown in Figure 4, where there is a well defined, optimum legal density.
167. Although we are doubtful that any significant reliance can be placed on these results (because of the level of abstraction and aggregation), it can be noted that, depending upon the precise specifications of the equations, Magee estimates the optimal legal density to lie in a range from about 2 to 2.5 lawyers per 1,000 of population. On this basis, he concludes that around a third of lawyers in the USA in the early years of the 21st century could be classified as ‘excessive’.
168. Magee’s interests lay in the US debates, but it can be noted that, if the EU member states in his sample⁶⁸ are treated as a single unit, the European legal density at the relevant time (circa 2000) is 1.65, significantly below the ‘optimum’ range (although subsequent relative growth of legal services in the EU, discussed above, can be expected to have narrowed the gap, and in own later figures, shown in Table 3, the EU density is 1.8 on the basis of a larger sample).

⁶⁸ The data period precedes the 2004 accessions to the EU, and we have therefore excluded observations such as Hungary and Poland in the EU calculations. Had they been included, the effect would have been to reduce the estimated density a little.

Figure 4: Average unaccounted for growth and legal density



169. At the level of EU member states, only Spain and Greece were above the ‘optimum’ range, although both had a legal density below that of the USA and of the country with the highest legal density, Uruguay, with 4.17 lawyers per thousand of population. On the basis of Magee’s statistics, Italy and Ireland were within the ‘optimum’ range, and all the other EU member states in the sample were below that range, including the UK, notwithstanding that the UK has an exceptionally high level of legal services exports, and might, therefore, be expected to have a particularly high density. On the other hand, using the figures shown in table 3, Italy would, like the USA, be classified as having ‘too many lawyers’. This again illustrates the data problems in this area of research.

The number of professional regulations and economic performance

170. An alternative way of assessing the effectiveness of the legal services sector is to focus not on the number of lawyers, but on the various restrictions or rules that exist in the profession. This approach is one that has been adopted in a number of studies in the European debates on professional services, where typically some form of stock-taking or inventory of professional restrictions in the legal sector is undertaken and then used as the basis for a form of econometric analysis. A common working assumption in these studies is that the higher the number of restrictions in a profession, the poorer is likely to be the economic performance of a sector.⁶⁹

⁶⁹ We note again that this apparently obvious assumption does not flow easily from economic theory, as is perhaps most directly illustrated by reference to the empirical proposition that *freer markets tend to*

171. An influential example of such a study was the report by the Institute of Higher Studies in Wien (IHS) prepared for DG Competition in 2003.⁷⁰ There was considerable discussion about the robustness of the analysis and conclusions of the study, and it is not our intention here to re-visit that discussion. However, the relevance of the study for current purposes lies in the general methodological approach it adopted to assess the economic impact of regulation in the professions. Specifically, the approach was one that, in the words of the authors, sought to “*determine whether there are any indications of causality between the performance of individual EU member states in each of the four professional service areas, and the degree of regulation as expressed in the indices of regulation*”.⁷¹
172. In essence the IHS study’s approach was to develop a ‘regulation index’ for legal services (and three other professions) based on various characteristics/variables related to market entry and conduct in each country. Each of these characteristics/variables was assigned a subjective weighting.⁷² The regulation indices for each country were then ‘benchmarked’ and countries ranked according to the regulation indices for each profession. Finally, the regulation indices for each country were correlated with various economic indicators such as: the number of firms, turnover, employment numbers, population and GDP. As stated, the intention of this exercise was to examine the relationship between the regulation indices and these economic indicators.
173. As a result of this analysis, the following specific conclusions were drawn: some countries with high regulation indices (like Austria and France) have low numbers of lawyers, and a high turnover to professional ratio. Countries with low regulation index scores (such as Netherlands, Denmark, Finland and Sweden) also have a low number of lawyers, but have a slightly lower turnover per professional. Germany is however an exception as it has a high regulation index, and yet the turnover per professional is relatively low. In terms of high-level conclusions, the study finds, among other things, that

have more rules, and noting that rules amount to restrictions on conduct. The appropriate question for economic purposes, therefore, is not whether there are more or fewer rules, but whether the effect of rules – whether assessed in their entirety, in subsets, or individually – is to expand or to contract the level of market activity. The only certainty in this is that a situation of no rules (no restrictions on human conduct) is restrictive of economic activity, since markets, like all other human institutions, cannot exist without rules.

⁷⁰ Institute for Advanced Studies (2003) “Economic impact of regulation in the field of liberal professions in different Member States” Report for European Commission DG Competition.

⁷¹ Ibid, page 94.

⁷² As an aside we note that some of the weightings appear to be quite subjective. For example, price or fee restrictions receive the same weighting as do restrictions on business and inter-professional co-operation, for no very clear reason.

there is a negative correlation between the degree of regulation and productivity in legal services.

174. The overarching conclusion of the authors, and one which relates to the points made in the previous section on the optimal number of lawyers, is that the empirical analysis points in the direction of private interest theories of regulation, and in particular, those aspects based on the idea of ‘rent seeking’. Moreover, they conclude that the evidence points in the direction of various restrictions inducing sub-optimal outcomes for the whole economy, and for consumers in particular, including in legal services in many EU Member States.
175. The central problem with these conclusions is that the various key ratios developed for the purposes of the benchmarking exercise are simply too crude to be relied upon. Put slightly differently, no real hypothesis or proposition is being tested in the analysis. Whilst the study claimed that it was testing for *causality* between economic performance and the degree of regulation in each Member State, in fact, no concrete, developed casual relationship is specified at the outset. Taking the example above, the study did not explicitly set out a hypothesis regarding the relationship between regulation and the number of lawyers and the average turnover of lawyers. It is perhaps unsurprising then, that when the results suggest that the association between these variables does not show any pattern, it is difficult to draw a conclusion regarding the relationship between these variables (in technical terms we have no null hypothesis to reject or accept).
176. There are also other limitations associated with this type of approach. First, there are many factors that could potentially affect the economic indicators used in the analysis that have simply not been accounted for in the analysis. Differences in terms of institutional/organisational arrangements (such as general employment or taxation laws), differences in demand, costs, school/tertiary education, and other factors are not captured in the analysis. They are in, technical terms, ‘omitted variables’. However, as is generally the case, the fact that they are omitted from the analysis does not mean that they do not influence the various economic indicators of interest. In plainer language, omitted variables equates to neglect of potentially relevant evidence.
177. A second limitation, and one that is acknowledged by the authors,⁷³ is that the analysis does not attempt to associate different forms of restrictions with differences in the *quality* of outputs. The working assumption is that there is a reasonable degree of homogeneity in the quality of services provided (which is supported on the basis of reasoning that there has been no apparent

⁷³ IHS, op cit, page 5.

break-down of markets where there is low regulation). However, for reasons noted in the previous sections of the report, perhaps the most compelling economic rationale for the regulation of legal services is related directly to the issue of quality. Put simply, it may very well be the case that one country which has a relatively high regulation index – say because it has a relatively higher education/training requirement – may have lower levels of turnover per lawyer, *but* the quality of the legal advice that is provided is of a higher standard than another country which has a lower education/training requirement, but has higher levels of output per lawyer. As discussed in earlier sections of this report, given the nature of legal services, the impact of having of higher quality legal advice can have both direct effects on consumers of legal services (in terms of better advice, and potentially more just outcomes) and indirect outcomes in terms of facilitating economic expansion in the economy more generally. Recall, for example, that one of the problems associated with the development of legal systems in some less-developed economies is that the quality of lawyers has been perceived to be low (with some lawyers not receiving formal legal training). In these circumstances, an economy might paradoxically score low on the regulation index, and potentially have a high number of ‘lawyers’ but this does not necessarily correspond to ‘better’ laws or legal advice being provided to consumers.

178. A further limitation of the analysis is that no account is taken of the contextual differences associated with the substantive law in different EU jurisdictions in making such a comparison. While this may not matter in the case of some professional services like dentistry or architecture, in the case of the law such a failure to account for different contexts can potentially be significant. That is, assuming that lawyers in different EU member states may possess a common technical skill/ability to interpret and apply laws, the substantive content and processes in which that legal system operates can be quite different in each country and reflect a wide range of different historical and constitutional factors. This can make the task of applying the law more complex in some countries than it is in others. To borrow the analogy from the discussion in the next section, while all taxi drivers across Europe may know how to operate a car and drive safely, the terrain that they must master can differ significantly across different cities and locations; some may require a high level of familiarization with a local area (the position of one-way streets or cul-de-sacs), while others may be relatively straightforward.
179. Related to the above point is the implicit assumption in the analysis that all regulations will tend to restrict economic performance. That is, there is an the implicit expectation that, in general terms at least, lower scores on a regulation index should/will be associated with higher performance on various economic indices. The authors suggest, in this respect, that the lower

regulation strategies of some countries could be applied in others without decreasing quality. However, as we have discussed in section 3 above, not *all* regulation of market entry and conduct will result in adverse economic effects. Indeed, in some cases quite the opposite is true: some degree of restriction on entry and conduct may be necessary to ensure confidence in the legal profession and legal transactions, which can enhance economic performance.

180. It follows from these points that while the IHS study provides a potentially useful compendium of the different restrictions in the legal profession across the EU member states at that time, and could potentially be useful for policy in that respect (i.e.: in terms of identifying the specific types of restrictions in place) we would suggest approaching the benchmarking analysis in the report with considerable caution. In our view, if this type of analysis was to be relied upon in policy making it would need to be undertaken in a much more developed and more expansive analytic framework (i.e. one that allows for the influence of a wider range of contextual factors), but the latter is generally much more feasible if a case study approach, rather than a cross-sectional econometric approach, is adopted. For these reasons then, we are of the view that the econometric/benchmarking approach is not well suited to the issues that arise in legal services, where there is likely to be a need for a detailed and forensic assessment of different professional restrictions on conduct in terms of both their purposes, the proportionality of the restrictions and their possible effects on economic outcomes.

181. A more recent study on the potential economic impacts of the legal profession at the European level has been prepared by CSES for DG Internal Market.⁷⁴ Although the nature and scope of the study is much wider – it is focused on providing an inventory of reserves of activities in the construction, business services and tourism sector – the general analytical approach of the CSES report shares some characteristics with the IHS study. Specifically, CSES use the inventory of reserves of activities it develops to construct an index of market entry restrictiveness, which is then weighted. This weighted index of reserves of activities is used as part of a ‘rank correlation analysis’ for the purposes of observing whether there is an inverse relationship between the reserve index and market size. The index is also regressed against various economic indicators such as sectoral turnover, employment, productivity and firm size.

182. Without going into detail on the CSES study, we offer the following general observations on the methodological approach that has been adopted:

⁷⁴ Centre for Strategy and Evaluation Services (CSES) (2012) “Study to provide an Inventory of Reserves of Activities linked to professional qualifications requirements in 13 EU Member States & assessing their economic impact”, Report for DG Internal Market and Services, January 2012.

- As with the IHS model, a major limitation of the economic analysis is that it is not conducted according to a well-specified economic framework, which attempts to specify the various casual relationships between different variables. In short, factors that would undoubtedly effect the analysis are not specified and included in the economic model that is applied.
- The general analytical approach appears to be one of seeking to confirm, rather than test, specific *a priori* assumptions regarding the nature of the association between the different variables. For example, the authors state: *As part of the analytical framework, key assumptions have been developed as to the types of economic impacts that might be expected to materialise as a result of the presence of exclusive reserves of activities. The purpose of the economic analysis was to assess whether these assumptions can be confirmed, in particular through the quantitative analysis (i.e. the regression and assessment of knock-on effects).*⁷⁵ There are a number of problems with such an approach, not least of which are (a) confirmation bias and (b) the fact that the different *a priori* assumptions are not fully specified in the analytical framework (i.e.: in what are called the structural relationships between different economic variables are not at all fully developed).
- Related to the previous point, it appears that many of the assumptions that are tested regarding the expected association between different variables are based on the standard-conduct-performance paradigm. In general terms, this approach to economic analysis, which was very popular in the 1950s and 1960s, works on the assumption that specific market structures will lead to particular behaviours and outcomes. While this approach is still prominent to varying degrees in economic assessments, there are a number of well-recognised limitations of the approach. Perhaps the most important of these is that market structure is itself endogenous, and correlations between structure, conduct and performance may reflect the influences of more basic, underlying factors, rather than causal relationships between the variables themselves.
- The need for caution when considering this analysis is perhaps best illustrated by examining some of the key results of the study. On the one hand, the regression analysis finds a statistically significant negative association between an increase in the reservation index and average firm size, implying that the higher the level of reserved activities in the legal sector the lower the average firm size. On the other hand, the coefficients

⁷⁵ Ibid, page 62.

on other variables like employment, turnover or value added are all positive (but not statistically significant), implying that increases in reserved activities in the legal sector is potentially associated with higher turnover, higher employment and greater value added.⁷⁶

183. To summarise, we have two general concerns with the recent studies of the economic impacts of the legal profession that have adopted a quantitative or econometric approach. First, the studies have tended not to specify an appropriate economic model or framework which can capture the different influences on the variables of interest, and allow for the ‘testing’ of various hypothesis regarding the nature of the interaction between specific variables. Second, the studies have tended not to clearly define or elaborate a specific counterfactual to what is being assessed. Put differently, while the studies present various measures of the relationship between levels of regulation and economic characteristics, it is not immediately apparent what these measures should be compared against. For example, it is not clear what conclusions or inferences can be drawn from the observation that a country with a relatively high regulation index tends also to have a large number of legal enterprises (such as appears to be the case for Italy and Spain). Should we infer that the high regulation index is correlated with a more competitive market structure, because more enterprises means less market concentration, or that the large number of enterprises should be read as signal of cartelization of the market (because more enterprises can survive in cartelized markets), or neither of the above? The methodological approach adopted gives no way of answering these questions, which is just another way of saying that it provides us with very little information of value in assessing the performance of alternative sets of rules.

5.3 Summary

184. Leaving aside the fact that the quantitative studies do not address the wider issues identified in the opening sections of this report, and instead focus on much narrower and limited aspects of economic performance, our views on the approaches considered in this section can be summarized very briefly:

- The comparative, international statistics used in many of the studies are of very poor quality. In particular, the numbers do not appear to have been prepared on a consistent, standardized basis. This alone raises a fundamental question about the validity and reliability of any relationships discovered.

⁷⁶ Ibid. There is a very small negative (-0.001) non statistically significant association between reserved activities and average labour productivity. Table 3.29 page 97.

- The econometric studies seek correlations among variables, which then tend to be over-interpreted in terms of the implications for the existence of causal relationships, as for example between the number of reserved activities in different jurisdictions and measures of the performance of the legal services sector. The analyses tend to lack robust economic theorizing that is capable of identifying testable hypotheses, relevant counterfactuals, and directions of causality. The studies tend to leave the reader asking *so what?*
- In order to keep the statistics manageable, and constrained by the availability of data, the studies tend to focus on a small number of relevant economic factors/variables. In effect, all other factors are omitted. Another way of putting this is to say that potentially significant information and evidence is ignored/neglected.
- In terms of the general discussions, there appears to be a radical failure to recognize that some restrictions of business conduct (i.e. some ‘rules’) can be expected to have expansionary, not restrictive, effects on the level of market activity.

185. In contrast, our own view is that a much more productive approach to understanding regulatory issues in the EU legal services sector is to undertake detailed, comparative, case-study work; which is capable of approaching issues with a much wider field of vision, and which is much less prone to the neglect/omission of relevant evidence. Case-study work can also trace the histories of changes in rule-books, codes and other institutional structures, and therefore offers a much better prospect of being able to distinguish causal relationships from relationships that are simply a reflection of underlying, confounding factors.

6: EMERGING TRENDS AND REGULATORY ISSUES

187. In this final section of the report, we examine some emerging trends and regulatory issues in the legal services sector, and briefly comment on them in light of some of the themes developed in the earlier sections of this report. We then focus on three specific current regulatory issues: competition between lawyers; issues associated with organisational/ownership structure (such as the introduction of alternative business structures); and possible changes to reserved activities and qualification requirements.

6.1 Some emerging trends

188. A number of important market/structural changes appear to be occurring in some areas of legal services, which are likely have an impact on how the sector is organized and operates in the future.

189. We have already discussed in section 2 how legal services, by reducing what economists call transactions costs, can have substantial, expansionary effects on levels of market activities. Today, across many sectors of the economy, transactions costs are being transformed by developments in Information and Communications Technology (ICT). Given that ICT and legal activities serve a similar purpose – reducing transactions costs – it can be expected that developments in ICT will have major implications for legal services markets going forward. Some of the effects are already visible, and more can be expected.

190. This trend creates both opportunities and challenges for the legal profession and for the legal services sector more widely. In the view of some commentators, there will be an increasing commoditization of legal services and some parts of law will come to be seen as an ‘information product’.⁷⁷ This could provide opportunities for lawyers who are able to be more multi-disciplinary in their outlook, and who are able to adapt to the restructuring that is occurring within the profession. On the other hand, these views that the role of lawyers will necessarily change, are not universally held, and there are other views that suggest that the changes in the profession will not be radical. Nevertheless, even the most conservative of views would likely acknowledge that developments in ICT are already changing the way lawyers work in *some* areas. Examples of these changes include the use of data rooms and e-discovery for litigation.

⁷⁷ See, for example: R Susskind (2008) *The End of Lawyers* (Oxford University Press). B Kobayashi, and L Ribstein (2011) “Law's Information Revolution” *Arizona Law Review*, Vol. 53, page 1169.

191. Another example of fundamental change is the increasing trend toward outsourcing of some tasks to jurisdictions outside the EU, which would have been uneconomic in days when communications costs and delays were much greater.⁷⁸ According to the WTO, although there are no very solid data on the extent of outsourcing, it is believed that India is a major destination for many outsourcing activities. One study, cited by the WTO, estimates that the value of legal outsourcing in India had grown from \$146 million (US) in 2006 to \$640 million by 2010, and that associated employment had increased from 7,500 to 32,000 over that same time period.⁷⁹ In addition to India, it is suggested that US and UK law firms in particular have been outsourcing work to Australia, Canada, New Zealand and South Africa to take advantage of the lower costs in those countries and of the benefits of zonal time differences in helping to complete tasks within shorter time periods.

192. There is also a potentially increasing role for para-professionals in the sector. In particular, it has been suggested that, as a result of developments in technology that allow for the standardization of certain routine tasks, and as a result of new ways of discovering, accessing and transmitting information about the law, there may be a reducing need for the ‘traditional’ lawyer. In short, it is argued that, to the extent to which routine legal work becomes commoditized and can be undertaken by advanced systems supported by less qualified individuals, some traditional lawyers may find themselves challenged by less-costly employees who have lower levels of training and skills. While such a development remains speculative, the possibilities may need to be borne in mind when considering future market and regulatory prospects.

193. A third general trend in some jurisdictions is pressure on lawyers to be more multi-disciplinary in the provision of services by working in conjunction with other ‘information processing’ specialists, such as accountants, business consultants or taxation consultants. An associated pressure is for lawyers, particularly business or commercial lawyers, to adapt to be more like other forms of business advisors (like accountants and management consultants).

194. In the view of some commentators, all of these trends presage a protracted period of turbulence for the legal profession. In the face of such

⁷⁸ Examples of tasks that are outsourced include: document review, legal transcription, litigation support and legal publishing services. Although it is suggested that increasingly, higher value tasks are also being outsourced. See World Trade Organization (2010) ‘Legal Services’ Background Note Prepared by Secretariat, page 7.

⁷⁹ According to the WTO: “*Offshore companies are reported to charge up to US\$25 per hour for lower-end work, and up to US\$90 per hour for more advanced tasks. A junior Indian lawyer is estimated to earn just over US\$8,000 per year, compared to some US\$160,000 for an associate in a major US city.*” Ibid, page 7.

changes, cumulative economic knowledge contains both a positive message for lawyers, and a warning.

195. On the positive side, markets are much better than bureaucracies in handling uncertainty and change. Indeed, it is precisely in adapting to uncertainty and change that markets have their greatest advantages over central planning and other forms of centralised decision-making, such as public regulation. The ICT revolution itself is a demonstration of this superiority – Soviet rifles and rockets could rival US rifles and rockets, but there was no contest when it came to the development of microprocessors and software (and many of the other major innovations of recent decades). The lessons of economic history are therefore positive insofar as they point toward the superiority of public policies which allow participants in legal services to themselves develop the necessary adjustments and adaptations to the new challenges, with only light handed guidance from public institutions.

196. The warning arises from the finding, in the historical record, that situations of fundamental change often call forth agitation for centralised intervention. Contrary to the economic evidence, there remains a propensity to seek action from government in challenging times. In economic terms, the problem with this result is that the direct actions of governments to intervene tend to crowd out, or interfere with, the adaptations taking place in markets. The result is, very often, to impede the adaptive process. This is perhaps the most substantive risk facing the legal services profession as it seeks to come to terms with the implications of the ICT revolutions and other changes discussed above.

6.2 Competition issues

197. Turning to specific regulatory issues, a recurring question is whether the structure of the legal services sector in some jurisdictions is such that it may be giving rise to anti-competitive effects. There are both price and non-price aspects to this discussion. In terms of price effects, as discussed above, in EU jurisdictions formal restrictions on prices (such as minimum prices determined by professional associations) have withered away as competition law has developed; which from an economic perspective would ordinarily be presumed to be a positive development (horizontal coordination of prices being one area where almost all economists would express concerns about adverse effects on competition). However, notwithstanding the fact that formal coordination of prices is no longer widespread in EU member states, a concern sometimes voiced is that the levels of concentration in the supply of legal services in particular areas of practice or specific geographic areas are such as to permit tacit coordination of fees among different suppliers of legal services. As we have argued in a previous paper, whether or not such implicit price

coordination is occurring is generally a matter for investigation under the relevant competition laws, and does not provide a obvious rationale for regulation over and above that which is already embodied in existing EU competition law.

198. In terms of the standard criteria for assessing competition under competition law, it can be noted that the legal services sector in most EU countries tends to score well compared with many other markets. In particular, levels of supplier concentration are low by most comparative standards. Table 4 above, for example, suggests that there were in excess of 492,000 legal enterprises in the EU in 2009, and that in most countries there were more than a thousand legal enterprises. Of course, these figures do not capture areas of legal practice that are more specialized, and where levels of market concentration are greater, but in general, it seems reasonable, on these numbers, to assume that, in majority of EU countries and across areas of specialization, a significant number of law firms compete with one another.

199. In relation to barriers to entry into the legal profession, it is appropriate to distinguish between entry restrictions that relate to quality of service in one way or another, and those which relate to quantity. In general, straightforward quota restrictions – i.e. restrictions on the number of lawyers who can practice in a particular area – are much the more problematic in terms of potentially adverse effects on competition, because they imply a direct restriction on the maximum level of supply. Although, legal services are sometimes grouped together with activities in which strict quantitative restrictions are imposed, in the main the nature of the restrictions relating to entry to the profession are linked to quality standards rather being simple caps on the number of lawyers.

200. To see the relevance of this distinction consider the example of taxis. The introduction of a quota or restriction on the number of taxi licences issued is a clear example of anti-competitive behavior: it artificially limits the supply on the market, presumably with the purpose of increasing the ability of existing taxi license holders to charge higher prices than would otherwise be possible. However, a requirement that all taxi drivers are appropriately trained and qualified (i.e.: in the case of a major city like London, by virtue of a requirement to pass a test to show they know their way around) and of good character (i.e.: no criminal record), is directed at improving the quality of the services provided by taxi drivers, and therefore consumer confidence in taxi services. This type of rule has two major features that distinguish it from quota rules:

- In the event that the market is undersupplied, new service providers are able to enter.

- Other things equal, higher quality service induced by the training requirements can be expected to have market-expanding (rather than restricting) effects. In the case of taxis, for example, confidence that drivers know their way around the relevant city will tend to boost demand for taxi services relative to other modes of transport.

201. It does not follow, however, that training or qualification requirements are always unproblematic in terms of competition effects. For example, requirements that are disproportionately high in relation to the skills associated with effective service provision will tend to raise the costs of entering a profession and, over the longer term, can be expected to lead to higher prices than are necessary for efficient supply (so as to remunerate the higher entry costs).

202. Faced with the task of assessing the economic significance of training and qualification requirements in legal services, the conceptual question for the competition authorities is a relatively straightforward one: are the requirements disproportionate in relation to the skills required for effective service delivery? If they are, that would count as evidence of a barriers to entry issue; if they are not, the ‘conduct restrictions’ (rules) can be expected to have expansionary, rather than restrictive, effects on the market.

203. Although the question may be relatively straightforward in conceptual terms, the assessment itself may take competition law into unfamiliar territory, which its practitioners may be reluctant to enter. The underlying issues are very general, and we have discussed them in previous work for the UK Legal Services Board. In brief, the ‘professional rules’ adopted by or for lawyers have the potential to promote market activity, and there is a common interest in securing sets of rules that are conducive to expansion and growth in the supply of legal services. At the margin, however, lawyers can benefit from rules that go ‘further than necessary’ to address the problem that might otherwise undermine consumer confidence (e.g. malpractice that damages collective reputations, conflicts of interest, etc.) and have negative effects on the volume of market transactions. This suggests that careful balancing is required in the assessment of rule-books governing the supply of legal services, based on the recognition that the constraints on behaviour that they embody can have both expansionary and restrictive effects on the relevant markets. The appropriate economics, therefore, is based upon case-by-case examination of the likely effects of variations in rule-books (i.e. variations in the institutional structure), taking account of both the specific context and of the broader implications of legal services activity (such as those discussed in the opening sections of this report).

6.3 Regulation of ownership and business structure

204. A good illustration of the trade-offs that can arise in conducting this type of assessment is provided by restrictions that exist in relation to ownership and business structure in the legal services sector. As noted above, economic analysis does not provide any clear-cut, *a priori*, answers to the question of the most efficient way to organise economic activities. The only general conclusion from this body of work is that the most efficient institutional structures will depend upon context, and that, generally, competitive processes should be allowed to operate to discover these institutional structures. It follows that, to the extent to which restrictions on business structures limit the ability of firms to innovate, or try alternative ways of doing business that might increase efficiency, they are liable to be restrictive of competition. It is for this reason that, in most sectors of the economy, the general position with respect to ownership and business structure is one of *laissez faire*.

205. There are, however, some important exceptions to this position. For example, in the area of the utilities – namely energy, telecommunications, rail – an important aspect of the *liberalisation* agenda at the European level has been *separation* of different business activities and of the ownership of various aspects of the production chain.⁸⁰ That is, policies have been introduced which have, in effect, prohibited particular organizational and ownership structures.

206. This is a large and complex area, on which we have written extensively, but the feature that is most relevant to legal services relates to the motivation behind such policies which, in a nutshell, is to address concerns about conflicts of interest (broadly defined) that can arise under some organisational structures. For example, an electricity generator wanting to enter a market where the transmission network is also owned by the main incumbent generator may be deterred from doing so because of a fear that the incumbent may discriminate against it. In particular, the generator entering the market will be aware that when it comes to negotiating the terms of access to the transmission grid, the integrated supplier of transmission services has a conflict of interest: a new generator will be a new customer for transmission services, but a competitor in generation. Knowing of this conflict, new entrants might not even try to enter the market (this is what happened in Britain in the period after the Energy Act 1983). The perception of a conflict

⁸⁰ For example, in Europe requirements relating to different types of separation (legal, functional ownership) have formed part of the various energy packages. The third energy package, which became effective in 2011, gave EU Member States the option between the full ownership separation of the generation and supply operations from the transmission activities, or introducing an independent system operator (ISO) or independent transmission operator (ITO).

of interest has a chilling effect on the size of the market, and the separation of ownership of the two activities, transmission and generation, has therefore been pursued, as a matter of public policy, to expand the market (end the restriction of the market).

207. Utilities are not the only case where requirements relating to ownership and organisational structures have been introduced to address potential conflicts of interest. Perhaps the most topical example of where such requirements are being considered is the banking and financial services sector. Such restrictions are not historically novel in the sector. The US Glass Steagall Act of 1933 was aimed at limiting connections between commercial banks and securities firms. More recently, in the UK consideration has been given to various forms of ring-fencing or separation of activities of banks as part of reforms of the banking sector.

208. Although the principal motivations for the separation of activities within financial institutions are based on the systematic dangers associated with having banks exposed to different types of risks, there are important aspects of business separation that relate to the culture of the relevant organization. In banking, for example, there are clearly differences in the most appropriate business cultures for commercial high-street banking, which in many ways is akin to a utility service provider, and in more speculative investment banking. In his highly regarded book on the causes of the recent financial crisis, University of Boston Professor Laurence Kotlikoff argues that the financial collapse can, in part, be attributed to a culture of ‘gambling’, which is no longer one based (as the title of the book suggests) on the image of Jimmy Stewart who is “*honest, warm, kind and trusting*”, but on “*fast-talking con-artists, riverboat gamblers and highway men who you would never trust with your money, let alone your kids, if you really got to know them*”.⁸¹

209. The general issue then – which may or may not be linked to competition issues – is that of conflicts of interest and of how best to regulate potential conflicts of interest.⁸² Whilst, in general, restrictions on business and organisational structure should be generally avoided as potentially restrictive of competition, in some circumstances policies directed at the avoidance of conflicts of interest may be important for market and economic activity. This is because perceptions of conflicts of interest in particular activities/markets can limit the confidence parties have in engaging with the activities of that

⁸¹ L Kotlikoff (2010) *Jimmy Stewart is Dead: Ending the World's Ongoing Financial Plague with Limited Purpose Banking* (Wiley Publishers).

⁸² As noted above, we have defined ‘conflicts of interest’ broadly to capture issues relating to the independence and integrity of the legal profession. Put differently, a conflict of interest arises whenever a lawyer’s independence or integrity is challenged or compromised.

market, which can reduce the overall level of market activity and potentially result in adverse economic effects.⁸³

210. Removing existing restrictions on legal service provision to allow for non-lawyer ownership of a law firm is frequently argued to increase the risk of conflicts of interest, and undermine the integrity of the legal profession to the ultimate detriment of consumers.⁸⁴ These arguments seem, in general terms, consistent with some of the points that emerged from the earlier sections of this report which focused on the wider benefits associated with particular characteristics of the legal profession.

211. On the other hand, while ownership and other business form restrictions in the legal services sector may be justified on the basis of reducing conflicts of interest and maintaining the integrity of the profession, they may, consistent with the general problem identified above, go further than necessary to achieve their purposes. That is, they may be disproportionate to their aims, and lesser forms of restrictions might be capable of achieving the same aims with fewer constraints. Accordingly, and again consistent with general points already made, a careful consideration of the proportionality of any restrictions on ownership and business structures may be merited.

212. Such assessment of proportionality should, in our view, involve a consideration of the following types of factors:

- The types and nature of conflicts of interest that might occur under different organizational structures.
- Their likely effects on the level of market activity.
- Evaluation of methods of preventing conflicts (such as ownership separation)
 - Are they effective in reducing conflicts?
 - Are there more effective ways of doing things? (often put in terms of the question of whether the rules go beyond what is necessary,

⁸³ Ibid. Kotlikoff makes just this observation in relation to the effects of the lack of confidence in the financial services after the crisis, noting that: *“People need to have a reason to park their money anywhere near people who, it’s now clear, have been selling fake securities for years and have no intention of telling their investors precisely and honestly what they are doing with their money. Because investors have been burned so badly, they are more likely, going forward to be skittish and to quickly sell their financial assets on rumour or small signs of bad news. This spells greater volatility in the financial markets down the road....and such panicked selling can as we’ve seen, bring down major financial institutions, which then look to Uncle Sam for life support”*.

⁸⁴ See on this point the Opinion of Mr Advocate General Léger in Case C-309/99, *Wouters* [2002] ECR, I-1577 para [185]. Also the judgement itself: Case C-309/99, *Wouters* [2002] ECR, I-1577 paras [97]-[110].

but, given what we have said, going beyond what is necessary is pretty much the same as assessing whether other options would be more expansionary in their effects on market transactions)

213. The necessity for such assessment demonstrates there is no general, abstract (i.e. independent of context) answer to whether particular restrictions on ownership and business structure will be good or bad for economic performance.⁸⁵ Moreover, the question of restrictions in ownership and business structures should not be framed as an ‘all or nothing’ decision. Within this framework a range of alternative structures might be allowed, but then be subject to a licensing process, which requires that certain conditions be met, and to subsequent regulatory monitoring. Depending on the stringency of such conditions, the outcome may be economically similar to outright prohibition of certain structures (e.g. because the conditions and the monitoring deter adoption of the structure).

214. The last of these points is of some significance in the development of policy going forward. Whilst the UK has relaxed its rules on ownership of law firms in order to allow for the introduction of alternative business structures, the national regulations provide for careful supervision of businesses opting for these alternative structures. Consistent with what has been argued in earlier parts of this report, the new options amount to regulatory reform, not to simple deregulation: indeed the new UK approach is arguably more, not less, regulatory than the old, at least in terms of the resources required for supervision of the relevant activities. This mirrors similar trade-offs in utilities policies, where one of the central arguments in favour of ownership separation between monopolistic network businesses and potentially competitive businesses that make use of the networks has been that such separation can lighten the regulatory burden by eliminating conflicts of interests that would otherwise require careful policing.

6.4 Reserved activities and qualifications requirements

215. A final area of current regulatory interest relates to the scope of reserves of activities for lawyers, and requirements in relation to qualification that are applied in order to practice in these areas. As a general observation, we note that many areas of professional regulation, including legal services regulation, tend to be focused on controlling entry into particular areas of economic activity; reserved activities and qualification requirements being two ways in which this general effect can be achieved. For the reasons outlined in section 4 above, such restrictions are often justified on the basis of

⁸⁵ This is also the general position that has been reached in relation to the assessment of ownership and other separation options in the utilities. See OECD (2006) “Report on Experiences with Structural Separation”, A report of the Competition Committee.

issues related to quality, but, as already explained, they also create the risk of adverse economic effects through unnecessarily higher prices.

216. As we have discussed in relation to other restrictions, the benefits and risks of the rules need to be balanced through an assessment of whether the effects of the restriction tend to be dominated by negative effects on competition or by positive effects arising from higher quality of service and customer confidence and any associated wider benefits in terms of maintaining the integrity and independence of the profession. In short, matters can only be settled empirically, and not on an *a priori* basis.

217. Once more, the key question in assessments of this kind is whether the restrictions or practices tend to restrict or expand the size of the relevant legal services market. Restrictions genuinely associated with quality, which increase consumer confidence, can result in higher 'gains from trade'. In economic terms, gains from trade depend on the volume of transactions and the average benefits from (the average value of) a transaction. Putting the point differently, although an entry restriction might, when viewed narrowly, be described as a direct restriction of competition, its actual effect can potentially be to expand the size of the market (the opposite of a restrictive effect). In effect, what can happen in economic terms is that one informal restriction on the size of the market (linked to a lack of confidence about quality of service on the consumers) has been *eased* by the introduction of a second restriction. *Ceteris paribus* the second measure is indeed economically restrictive but, in reality, other things do not remain the same: they are affected by the second measure, which, when such indirect effects are taken into account, can be said not to have economically restrictive impacts.

6.5 Summary

218. We tend to agree with commentators who suggest that the legal services sector may face a considerable period of turbulence in the coming years, particularly as a result of changes in ICT and different working practices (such as off-shoring etc). These changes are likely to offer both opportunities and challenges for the profession, and the ability of the sector to adapt to these changes will be critical to its economic performance in the future.

219. Alongside emerging market and technological trends, there are a number of possible regulatory developments which could have both direct and indirect effects on the profession. We have considered in this section three areas on which regulatory attention is currently focused in at least some jurisdictions – on competition and barriers to entry; restrictions on business and ownership arrangements in the profession; and reserved activities and

qualification requirements. With respect to concerns about competition, our general view is that, to the extent to which problems exist relating to pockets of market concentration, or barriers to entry attributable to self-regulation, these should be addressable via competition law enforcement. In relation to the other matters of regulatory interest, our view is that in both cases the only way in which the economic issues can safely be approached is via an assessment of the trade-offs associated with the relevant rules, based on an examination of likely effects on competition and of wider impacts in terms of quality and consumer confidence, and the benefits this can bring in terms of sustaining the independence and integrity of the profession. The balancing of these considerations is necessarily a complex exercise, and we have suggested that a key factor that should be considered in the assessment is the effect that a given restriction will have on the gains from trade and whether it potentially increases or decreases the size of the market over the longer term.

220. More generally, a central implication of our analysis is that, because legal activities are so closely bound up with the institutions that are central to the effective functioning of the European Economy, assessment of regulation in the legal services sector can only validly and safely be conducted within a conceptual framework that recognizes and encompasses the central roles played by economic institutions, and by the factors that underpin them. An ‘institutionless’ economics is, definitionally, not fit for purpose in this regard, since it neglects or abstracts from things of great significance for the issues at hand. More than that, it is likely to mislead. Since the institutions that facilitate economic activity have the immediate effect of placing restrictions on the economic conduct of those participating in such activity, failure to recognize the facilitating effects leads naturally to the false conclusion that ‘rules’ that restrict conduct also tend to restrict markets and competition. And that would amount to a major intellectual error.